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Modern Business

A Series of Texts
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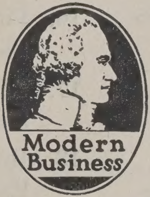
Modern Business Course and Service



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International Exchange

By Alexander Hamilton Institute
in collaboration with

E. L. Stewart Patterson

Superintendent, Eastern Townships Branches
Canadian Bank of Commerce

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VOLUME 18

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PREFACE

International exchanges have an unusual interest at the present time, and there is much confusion of thought in regard to the influences which fix exchange rates. They are in a highly sensitive state and like a person with shattered nerves react somewhat violently to changes in external conditions. This obscures to the onlooker the working of the fundamental principles which govern international payments. An examination of the seemingly mysterious but in reality simple underlying principles of international exchange should prove interesting not only to the exporter and the importer, but to business men in general who are concerned in watching the factors which make for a nation's welfare.

It would be impossible to understand exchange in its present dislocated and abnormal state without a thoro knowledge of its operation under normal conditions, and for this reason the basic principles which govern exchange under the latter have been fully explained, altho reference to the more important factors which influence the exchanges today has been frequently made.

In preparing the present volume, we have drawn largely upon the material furnished by Mr. E. L.

Stewart Patterson, Superintendent of Eastern Townships Branches of the Canadian Bank of Commerce, to whose ripe experience and profound knowledge of the subject of international exchange the greater part of the work is due.

JOSEPH FRENCH JOHNSON.

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INTERNATIONAL EXCHANGE

CHAPTER I

THE EXCHANGE SITUATION OF TODAY

1. *The established order crumbles.*—"In August, 1914," says Hartley Withers, "civilization went into the hands of a receiver, the God of Battles." His grip on the destinies of mankind has been broken but not entirely shaken off. What has been rescued from his grim hands is frayed and tattered, and the patient labor of many years will be required to repair the ravages of war and bring the affairs of the world, both political and economic, to an orderly basis.

No nation of the world, whether a belligerent or not, has failed to feel in some degree the consequences of the World struggle. Into every nook and corner of our business life its destructive fingers have reached and have twisted out of shape the old established order. It is only natural that these many changes should find their chief expression in international exchange, for here business relations appear in their world aspect.

2. *International exchange and civilization.*—That foreign exchange, the adjustment of all our financial

relations with the world beyond our borders, lies at the very basis of civilization is no mere figure of speech. Attempts to formulate in words just what the mind pictures by such comprehensive ideas as "civilization" are likely to be unsatisfactory. They say too little to be satisfying or they say too much to be concise and definite. One essential of civilization which all recognize, however, is that of orderly intercourse among men of the same nation and, as civilization advances, of different nations. Isolation whether of the individual or the nation is the contrast to civilization. Whatever hampers and impedes such intercourse promotes isolation, whatever facilitates intercourse between men and nations promotes civilization.

The first effect of the Great War on the United States was to break down the long established exchange relations between New York and London and other financial centers. It seems not unlikely that the reestablishment of stable exchange among the nations of the world may be the last step in the economic reconstruction thru which the world is passing. International exchange touches the heart of the economic situation past, present and future.

3. *Interest of the unusual.*—When business moves along in its accustomed gait we think very little of its operations, and we take as a matter of course the delicate adjustments of its various parts, just as a man in good health gives little thought to his digestive system. In normal times the slight fluctuations of inter-

national exchange may be of moment to the exporter and the banker—they are his professional interest—but they are of little concern to the business men of the nation at large. International payments which involve no shipment of gold arouse little interest in the business world. But when gold is exported or imported attention is immediately drawn to the fact, and from one end of the country to the other the daily press gives explanations more or less accurate of what is taking place.

Ever since the great conflict of the nations broke out in August, 1914, the disorder in our exchange relations with foreign countries has been followed from day to day with absorbing interest by men of business, as well as by the general and financial press. The machinery which determined the in-and-outflow of gold and thus regulated the rates at which adjustments between different countries were made was stopped. Violent fluctuations in these rates appeared and while, thru governmental rather than commercial means, these rates were steadied during the war, the period since the Armistice has been one of great variation and uncertainty.

4. *Fluctuating standards, national and international.*—In international relations such fluctuations in exchange rates cause disorders of the same nature as follow in domestic affairs from variations in the money standard. It is not necessary to depict in detail the difficulties which grow out of a fluctuating paper standard of money. Changes in its value in-

troduce an element of uncertainty into every business relation. Men live from day to day not knowing what the morrow will bring forth. Business arrangements become a series of temporary makeshifts. Men are unable to work and plan for the future because that future is vague and uncertain. Business is reduced to a minimum, and under these conditions the foundations of progress cannot be laid. Business does not stop,—it cannot stop—but it lacks enterprise and hope.

It is the same in international relations. The needs of nations remain as before. Interchange of commodities between the different parts of the world cannot cease. But with rates of exchange fluctuating from day to day intercourse between the nations is hampered in the same way as if tariff barriers were shifted frequently and capriciously.

5. *Normal exchange relations.*—In part the outgrowth of national needs for commodities which could not be produced at home, in part the outgrowth of political and financial relations, there had grown up in the years that preceded the War well-established commercial and financial relations among the nations of the earth. They were not fixed and immutable, but subject to constant tho from year to year relatively slight changes as conditions in the different countries varied. The economic literature of the day consisted in no small part of a discussion of how changes in one country affected conditions in another. It is a truism that the business structure of one coun-

try is only part and parcel of the business structure of the world at large. International exchange therefore reflects both internal and external conditions.

6. *Internal change wrought by war.*—Separating, as far as it is possible to do so, internal from external conditions, let us briefly summarize the events and legacies of the Great War which have entirely thrown out of balance the traditional exchange relations among the nations.

Among the belligerents there was a great destruction of productive property, and this destruction was not evenly distributed. Belgium and northern France were laid waste, and the fruits of centuries of the up-building process were wiped out. Other belligerents escaped this fate tho the Allied nations, particularly Great Britain, and some neutrals suffered considerable losses in shipping.

Among the belligerents again there was a great destruction of man power thru the sacrifices of battle and disease. Tho the phrase man power is frequently given a purely military meaning its significance for the world's production cannot be overlooked. Economists may speculate whether in certain areas there may not be overpopulation, but with a given population, none of them would look for any benefit from the destruction of its most active and productive elements. And again it may be noted that this destruction of life was not evenly distributed among the belligerent nations.

In all the nations participating in the Great War there was further a great destruction of potential wealth, thru the diversion of industry to the manufacture of the means of warfare, thru the attendant taxes and the huge legacy of debt which has been left for future generations to liquidate. Nor was this burden evenly distributed.

Nor could the neutral nations wholly escape the direct internal effects of the war. This was especially true of the Netherlands and Switzerland which were obliged to make relatively large military expenditures for the defence of their neutrality. The smaller neutrals in Europe and the larger ones of Latin America were indirectly drawn into the economic turmoil thru being cut off from sources of supply for their manufactures and personal consumption, and thru the difficulty in some instances in finding an outlet for their native products.

7. *Monetary disturbance.*—Thus during and after the war the nations have staggered under its burden. Their whole economic life was directed to the single purpose of warfare and all the checks and balances which guided it in times of peace were set aside. Nowhere could the monetary standard be maintained in its full integrity. Gold which had generally been the background if not the actual embodiment of the monetary circulation became exclusively a factor of government finance rather than the mainstay of commerce. The convertibility of currency into gold was suspended, and the only check on the issue of currency which civilization has established as effective ceased

to operate. Paper money under various names multiplied in the different countries at different rates, and suffered varying degrees of depreciation as revealed in the rise of local prices.

With such changes going on in the currencies of nations it was impossible for exchange rates not to be powerfully affected. When depreciation is uniform among a group of states it is conceivable that, other things being equal, exchange rates would not change. But "other things" were far from being equal in the world crisis and depreciation was far from being uniform in the nations concerned. Hence the fiscal relations of these nations not only with those which were able to maintain the integrity of their currency but also among themselves were shifted.

8. *External relations in wartime.*—Let us turn our attention to certain external relations. Western Europe is unable to produce all the food required for its dense population. Even before the war it drew large quantities of food from Eastern Europe and from other continents, exchanging manufactured products for it. It was the manufacturing center of the world, tho it had to draw upon other lands for many of its raw materials. The extensive commercial relations to which these exchanges gave rise had made London the financial center of the world, extending its influence into all the corners of the earth. To London, lands far and near looked for financial assistance. The loans of many governments were floated there, and both British and native enterprises

in all parts of the world—drew their capital from the same source.

Europe at war had more imperative needs than before. It needed more food, since its own production was curtailed. It needed arms and munitions and supplies for the murderous conflict in which it was engaged. In its extremity it turned to the United States, and the increased exports of food and of war materials from this country went far to supply its need. Enormous payments had to be made in the United States by the allied governments and a violent shifting of the usual trade relations occurred. Crippled by the war and the demands which it entailed, the London market was no longer in a position to lend capital to the rest of the world. Those in South America, Canada, even in Europe itself who were wont to borrow money in the markets of the old world, were forced to come to New York.

9. *Exchange before the war.*—In brief outline these are the chief changes—there are innumerable smaller ones—which have shifted and changed almost beyond recognition the customary exchange relations among the nations. What are the outstanding features of that situation then and now as they affect foreign exchange?

The significant thing before the War was the existence over large areas of international standards of value. Gold was the accepted medium of exchange in foreign payments over the greater part of the civilized world. A smaller group of nations used silver as its basis of money. Within the group the same interchangeability existed as in the gold group. Moreover it is to be noted that as silver is a commodity of world commerce a relationship to the gold group was always calculable. Outside of these two groups there were a few nations having only a paper currency with no metallic background. It was common to speak of them as being on a paper standard, but it is to be noted that such a standard is necessarily local and is not an international standard common to a group of countries. Exchange with any one of them therefore will be governed by considerations which do not apply, or apply in different measure, to another country.

10. *Present exchange situation.*—The distribution of the nations of the earth into gold standard, silver standard and paper standard countries has been completely changed by the war. Most of the leading nations are actually on a paper standard. They have not loosened their hold on gold, and in some cases their gold holdings have even increased since 1914. But paper money has greatly multiplied and gold is no longer available for local or for international commerce. Silver indeed has held its own in international payments, but gold has lost for the time its former importance.

How long the present conditions will be maintained no one can foretell. Certain it is that the nations which have heretofore used gold for local and international payments are looking forward to a return to that basis. They hope to return sooner or later to the normal condition of the free use of gold in international exchanges. Such normal conditions embracing both the past and it is hoped the future, have a permanent interest which does not attach to the present more or less temporary conditions.

11. *Plan of discussion.*—Before the War it was not necessary to explain or defend the traditional approach to the detailed study of international exchanges. Writers depicted exchange conditions with gold standard countries, with silver standard countries, and with paper standard countries in this sequence, not only because it treated the different groups in the order of their importance but because the discussion proceeded naturally from the simple to the complex.

If we were to follow today the importance of the different groups we should have to deal first with the paper standard, but in so doing we should plunge the reader into the most difficult phase of the entire subject. If we are to understand the principles of international exchange under conditions as they are, we must first comprehend them under conditions as they ought to be. That means that it would not be wise to depart from the traditional presentation of the subject which presumes the existence of gold as the international money. It does not mean that the unusual conditions of the present day can be ignored in the treatment. Nor does it mean that the emphasis on the different aspects of the subject will be the same as heretofore. Obviously greater attention must at this time be given to the factors underlying international payments between countries on a paper basis. Should any of our readers deem that the assumptions underlying the discussion of international exchange principles are somewhat remote from conditions as they are now, it would be well to remember that the conditions assumed are those which the future, it is hoped, will restore before the world grows much older.

REVIEW

In what sense are stable exchange and civilization linked together?

Describe the exchange situation before the Great War.

What internal and external changes wrought by war have affected the exchange situation?

What has been and is now the relative importance of countries using respectively, a gold, silver and paper standard of value?

CHAPTER II

FUNDAMENTALS OF EXCHANGE

1. *Clearing process in exchange.*—The fundamental principles of foreign exchange are simple. The actual methods of making international payments, however, and the calculations involved are somewhat technical. A student beginning the subject often rivets his eyes upon the maze of exchange calculations, technical methods and the myriads of varying circumstances which work together to fix the actual rates, thus losing sight of the underlying principles which are few and easily understood.

Every one knows that in foreign exchange the business world applies the familiar principle of offsetting one debt against another and arranging to adjust the balance either thru money or credit. This principle will be understood better if portrayed first in a simple illustration stripped of all the mechanism which civilization and commerce have developed.

2. *Settlement of equal debts.*—Let us suppose that Durant in Montreal has sold to Rogers in New York a bill of goods for $1,000. He draws a draft for this amount on Rogers who must make payment in Montreal. If Rogers sends currency or gold, he must pay insurance and transportation costs, and this

is an added burden to his business. Now suppose that at the same time Peters in New York has sold a $1,000 bill of goods to Martin in Montreal, making it necessary for Martin to send $1,000 to New York. Clearly, if all four parties were aware of these transactions, Martin the Montreal buyer could pay $1,000 to Durant the Montreal seller, and Rogers the New York buyer could pay Peters the New York seller. This would eliminate the necessity for any shipment of money.

3. *Settlement of unequal debts.*—Now let us assume that the debts in the foregoing case were not equal, that $1,500 is due to Montreal and only $1,000 to New York. In Montreal, Martin can settle with Durant just as before; but, in New York, after Rogers has paid $1,000 to Peters he must still remit $500 to Durant at Montreal. To ship this $500 will cost something but it will be less expensive than shipping the entire $1,500. Furthermore, the cost of shipping $1,000 from Montreal to New York has been saved.

Multiply the four men of our illustration by thousands, and we have a picture which more clearly corresponds to the actual situation. The multiplication increases the amount of debts to be adjusted; it may also diminish the proportion of the entire debt to be settled by currency shipments.

4. *The dealer in exchange.*—It may be objected that the above illustration is unreasonable, that we could not possibly expect the four men, much less

thousands, to discover one another's doings. The objection would be well taken. But suppose that no business man in either Montreal or New York undertakes to ship currency on his own account and that there is only one banker or exchange dealer in each place who is equipped to handle such transactions. Say, further, that the Bank of Montreal sends all remittances direct to the Bank of New York which distributes the payments to those entitled to receive them in New York and that, in like manner, the Bank of New York consigns all remittances to the Bank of of Montreal for distribution there. All business men in New York who owe money in Montreal will now pay their funds into the Bank of New York, and all those to whom money is due from Montreal will call upon the Bank of New York for it. The bank will know that it has certain remittances to make but that, on the other hand, it has certain remittances due from the Bank of Montreal. It will ship only the balance due Montreal or receive only the balance due New York.

5. *The exchange rate.*—The banker or exchange dealer evidently renders a valuable service, for which it is only just that he should be paid. So long as payments to Montreal equal payments to New York nothing but bookkeeping is involved, and the bank may assume the cost of this as an accommodation to its customers. Under these conditions exchange is said to be at par.

The moment a currency shipment, to Montreal for example, becomes necessary, it is only natural that the Bank of New York should make a charge. It cannot charge more than the expense incident to procuring the money and shipping it; if it should do so business men would ship for themselves.

The bank may anticipate the necessity of shipping currency before it actually arises. If business men in New York seem to be buying from Montreal more than they are selling, the Bank of New York may begin to make a small charge for its services in remitting to Montreal, increasing the charge as the probability of shipment becomes more certain. The cost is thus distributed over a larger number of buyers, who will pay the charge rather than ship money themselves as long as it does not exceed the cost to them if they should procure the money and ship it. Under these conditions exchange on Montreal is said to be at a premium in New York.

6. *Exchange at a discount.*—When Montreal exchange is at a premium in New York, what is happening to New York exchange in Montreal? There the sellers overbalance the buyers. Sellers draw their drafts upon New York and present them to the Bank of Montreal for cash. Some drafts are coming in from New York drawn upon Montreal business men who have bought goods, and cash is received for them; but not enough to meet the sellers' demand. Under these circumstances the Bank of Montreal may refuse to pay full face value for drafts on New York, and New York exchange is at a discount.

If the Montreal sellers have specified in their contracts with New York buyers that payment must be made in Montreal, they are fortunate. They need not sell their drafts to the Bank of Montreal at a discount but may simply demand that their debtors forward the money. If the contract permits payment to be made in New York, however, they cannot do better than sell their drafts at a discount. Of course, the discount cannot exceed the expenses of shipping the money from New York to Montreal, since they can accept payment in New York and make the shipment on their own account.

This illustration shows how important it may be for a sales contract to specify whether payment is to be made in money of the seller's city or in that of the buyer's.

7. *The exchange market.*—The assumption that there is only one exchange dealer in Montreal or New York is, of course, incorrect. There are many dealers or banks in each city where drafts can be bought and sold. The Bank of New York is in competition with other banks and dealers, and, under the circumstances described above, cannot charge a premium on Montreal exchange greater than its competitors charge if it would hold its customers. In like manner, the Bank of Montreal cannot discount New York drafts at a rate higher than that of its competitors if it wants to buy any.

So far it has been assumed also that New York and Montreal trade only with each other; but each trades with every other important city in the world. In Montreal, an excess of sales to New York over purchases from her may be counter-balanced by an excess of purchases from London over sales to that point. At the same time, New York may be selling more to London than she is buying. If so, New York can pay Montreal by drafts on London, thus avoiding shipment of money. Montreal is content, because she can forward the drafts to London instead of money.

8. *Exchange centers.*—It would seem that the practice just described would lead to boundless confusion. New York might send to Montreal drafts on Madrid when Montreal had a balance due from Madrid. Montreal might then send these to some other point where she did owe an amount and there again they might not be needed. How could any point determine what drafts to forward to another?

This difficulty was settled in the natural development of international trade. London and New York are two points with which almost every city in the world is trading. Remittances are always being made to these points and received from them. Consequently drafts on either may be remitted anywhere in settlement of debts, and they will be acceptable because points everywhere need such drafts to make payments in one or the other city. Drafts on other cities are sometimes used, but usually they are remitted to the cities on which they are drawn or to nearby cities. Drafts on any point are acceptable in New York or London because they have remittances to make everywhere. These two cities are the exchange centers of the world.

9. *Gold points.*—In a preceding paragraph we pointed out that the premium on Montreal exchange in New York could never go above the expenses incident to procuring the gold and shipping it. Shipping expenses consist primarily of the cost of packing, express, insurance and loss by abrasion. In a country which is not redeeming its credit money at face value in gold, it may be necessary to pay an additional amount to secure gold for shipment.

The principle which limits the premium on Montreal exchange in New York also limits the discount, except that here it is the expenses involved in procuring gold in Montreal and in shipping it to New York, that fixes the amount of variation.

Evidently, at a given time, there is a point above par beyond which the price of exchange cannot rise, and likewise a point below par under which the price cannot drop. These are the points at which it becomes profitable to export or import gold, and are often called the gold shipping points or gold points. It must be understood that they vary with the costs of procuring gold and shipping it.

10. *Demand and supply.*—The price of exchange fluctuates between the gold points according to the shifting of demand and supply. Every sale of goods by an American to an Englishman creates a supply of drafts on London; every purchase made by an

American from an Englishman creates a demand for London exchange. American sales to England thus tend to lower the price of London exchange and purchases from England tend to raise it.

Lowering the price of London exchange in New York means raising the price of New York exchange in London and conversely. It will be seen then that every export from the United States tends to lower the price of exchange on the buying country, which means raising the price of New York exchange in that country. Every import into the United States tends to lower the price of New York exchange abroad.

11. *Exchange as a trade factor.*—Thus far we have considered exchange as a result of trade activity. For a fuller view of the subject we must also recognize that exchange is an important factor in determining the trend of trade.

How this takes place can best be explained by considering a case that is hypothetical,—and, to lend force to the argument, absurdly so. Let us assume that in New York, Montreal exchange is quoted at 75. That means that $75 in New York in goods or money would be worth $100 in Montreal, and of course the converse would be true. If on the face of it, Montreal is an excellent place in which to sell, it would be a bad place in which to buy. What the New York merchant would gain on his sales would be lost on his purchases or his remittance. But since this exchange relation is wholly abnormal a return to par would be expected. If then when the New York merchant expects to cash in on his sale the rate should have advanced to 80 he would be the gainer by the rise in exchange and the hope of such gain would impel him to sell. On the other hand if exchange is falling the Montreal merchant would have no incentive to buy in New York but if from a low point it begins to rise he is likely to purchase and seek to reap the benefit of such a rise.

The assumed facts are fearfully exaggerated and frankly absurd. Yet they illustrate an important principle. Exchange variations as we have seen fluctuate within very narrow limits and one might well be skeptical whether these variations would start any such selling and buying movements as have been suggested.

Now the margins of profit on such operations are very slight. They would offer little incentive to trade to the grocer or the dry goods dealer. But there are other commodities and other markets which are extremely sensitive to changes such as these. First of all there is the money market, the market for securities of all sorts and the organized markets for grain and other produce. They operate on very small margins and thru the magnitude of their operations small profits become important sources of revenue.

Just how these various financial transactions are stimulated by exchange operations and affect exchange rates must be reserved for subsequent treatment. It is important at this point to note their existence.

12. *The role that money plays.*—In the preceding chapter there was considerable insistence upon the role that money plays in determining exchange relations. In the present chapter exchange has been explained largely as a means of making payments without the transfer of money. These two standpoints are only in appearance contradictory. The relation that money bears to the exchanges is exactly the same as that which it bears to other forms of credit operations. Banking operations dispense with one use of money, as a medium of exchange, but without money they would be inconceivable. The money function is a composite one and we are apt to speak loosely of doing away with the use of money when at best we simply economize one of its uses. Back of all credit transactions whether in local or foreign affairs stands money. It is the language in which they are expressed and, more than that, it is the medium thru which credit differences are adjusted. The more highly developed the credit system the smaller will be the amount which requires such cash adjustment, but we have not yet reached a point where we can entirely dispense with its use for such purposes.

Our explanations of exchange operations have thruout had the background of the existence of money equally acceptable to all parties to the transactions. When such a condition obtains the phenomena of exchange present their simplest forms.

13. *Exchange with foreign centers.*—The fact that two communities which trade with one another belong to different nations does not of itself affect exchange relations. Exchange operations may be affected by differences in currencies but the underlying principles remain the same.

Since the explanations thus far given assume the existence of money equally acceptable to all parties we may distinguish three different situations.

1. Where the money of two countries is identical and has completely free circulation in both.

2. Where the money of two countries tho identical does not circulate in both but is readily convertible from one to the other.

3. When the money basis is the same, but denominations different, with ready convertibility of one to the other with or without concurrent circulation.

If we go back a few years we find that the first condition prevailed in the relations of Paris with Brussels, Geneva and other points in the nations of the Latin Union, the second condition existed in the relations of New York to Canadian centers, while the third was found in New York's relation to London, Paris, Berlin and other centers of countries having the gold or the gold exchange currency standard.

It is to be noted that the condition of such exchanges is either concurrent circulation of money or its free convertibility or both combined. A word of explanation is perhaps needed with regard to the combination here noted which applies chiefly to gold.

The chief use of gold in the monetary circulation of most nations has been as a reserve for the banks. Inasmuch as the chief foreign banks are by law permitted to hold a part of their gold reserve in coins of foreign nations it is in a sense proper to say that the American double eagles stored in the vaults of the Bank of England had circulation in Great Britain. At that time the converse was not true. American banks could hold no part of their reserve in foreign coin and on receiving it had to transform it into American gold either in bars or coin.

In international exchange gold circulates by weight rather than by denominations, but there are certain forms such as the coins of the leading nations and bars of the leading mints which have the preference. It may be noted that an examination of the customs returns for gold imported into the United States ordinarily reveals that the greater part of it comes to the country in the form of American coin or American treasury bars and only a small part in foreign coin.

14. *Countries using the same money.*—If, as was formerly the case in the countries forming the Latin Monetary Union, the coins of one country circulate freely by law in another, exchange among them offers no problem. All exchange is expressed in familiar terms which allows even those not very well informed to perceive the premium or the discount. Quite similar is the situation in countries which use different coins which, however, have the same gold value, sometimes the same name. When before

the Great War New York traded with Montreal and settled its transactions by exchange operations, it was hardly aware of the fact that it was engaging in foreign exchange. The two places used the same dollar as to weight and fineness and exchange on Montreal and exchange on New York was in each case practically quoted in domestic currency. Exchange bridges the gap between two countries very simply, so long as there is the possibility of the free movement of money of the same kind. As we shall see later even the designation or value of the money unit is quite immaterial if the kind is the same.

Of recent years Canadian exchange has been at a marked discount. Such a discount would be impossible if the money in circulation were in effect of the same kind. This is not the case. As an aftermath of the Great War, Canada has been obliged to depart for the time being from the gold basis. So long as the paper money of the Dominion cannot be converted into gold, the gold standard which exists by law is in fact suspended. Under these circumstances the Canadian dollar is quite a different thing from the American dollar, tho under normal conditions they are practically identical.

Exchange rates between countries having the same monetary units as was the case between the United States and Canada a few years ago are readily understood because they are expressed in the same monetary language. Deviations from exact equality are measured in terms with which the business world is thoroly familiar.

15. *Countries using different coinages.*—A few years ago when London reckoned all its transactions in gold pounds sterling, and New York figured its dealings in gold dollars, exchange relations in appearance were somewhat more complicated than those which have been thus far discussed. This complexity lies however chiefly in the appearance. Both countries were using the same money metal, gold, and in both it was freely available for the needs of trade. The only difference lay in the coins used. But since in international affairs gold circulates by weight it is only necessary to compare the pure gold in the sovereign with that in the dollar to establish the relation in which, with exchange at par, one coin could be exchanged for the other. This ratio called the Mint par of exchange was £1 = $4.8665. When exchange on London cost more than $4.86 2-3 it was at a premium, when less it was at a discount.

16. *Countries with different money standards.*—Thus far we have discussed exchange relations between countries having a like monetary standard. The existence of what then becomes international money is helpful and convenient for the development of commerce, but it is not essential to it. Trade between countries on a different money standard continues and as we have seen in the preceding chapter is possibly the dominant form of international trade for the time being. It introduces, however, into the

fixing of exchange rates a variety of new considerations. For the orderly development of the subject it seems advisable to defer the consideration of these exchanges until there has been a full consideration of all the phenomena of exchange based on international money—gold. These phases of the subject will therefore receive first attention.

REVIEW

Explain the exchange as a clearing process.

How do you account for premiums and discounts in exchange?

What is the role of banker? What is meant by exchange market and exchange center?

Within what limits will exchange usually fluctuate? How are those limits fixed?

Explain how money is at the basis of exchange rates and the effect if any of different moneys of the same kind in the problems involved.

CHAPTER III

INTERNATIONAL PAYMENTS—ORIGIN

1. *How indebtedness between two countries arises.* —The mutual indebtedness of two countries arises from a combination of the following:

Exports of merchandise
Investments abroad
The purchase of foreign securities
Payments of interest and dividends to foreign shareholders
Charges for transportation, insurance and commissions paid to foreign corporations
Tourists' expenditures, etc.

There are, of course, many other causes which affect the course of the exchanges, but the above are the principal factors in the fluctuations. Normally, the balance of payment, as it is called, is sometimes with one country, sometimes with another, and the rate of exchange accordingly rises and falls within certain well-defined limits. Between countries on the gold standard these limits are determined by the cost of shipping gold from one country to the other. The rate of exchange may be defined as the price of the money of one country reckoned in the money of any other country, that is, the price of the right to gold of a certain established weight and fineness. As many countries have not yet removed their embargoes against gold shipments by other agencies than the governments, this price must temporarily be considered not as the price of their standard gold coin but of currency with the lessened quantity of gold behind it resulting from the increase of its amount in proportion to gold reserves.

The principal operations of foreign exchange include the issue of drafts and various forms of commercial paper, money orders, letters of credit payable abroad, cable transactions and the purchase and shipment of bullion and of foreign coin.

2. *Interdependence of exports and imports.*—If merchandise were the only basis of international indebtedness the value of the exports would have to be equal to that of the imports or else trade would practically cease. Suppose a country which does not itself produce gold, has an excess of imports, for which it could pay only by shipping gold. To a limited extent this could be done, but its supply of gold would soon be exhausted and the only way to replenish it would be to reduce the amount of imports below that of its exports. Furthermore, the loss of gold from a country induces a fall in the prices of goods (a rise in the value of money) and, owing to the depletion of the bank reserves, a rise in interest rates follows. It would, therefore, become a good country to buy from, and a poor country to sell to. Automatically, exports

would be stimulated and imports checked until the balance was reversed.

In practice, however, the exports of a country are not confined to merchandise but include other elements known as "invisible exports," which offset imports of merchandise. "Visible exports" consist of merchandise of every description, including gold; they are so called because accurate records of all goods and specie entering or leaving a country are kept by the customs and port authorities. Every vessel clearing from a port must declare its cargo before leaving, and all goods entering the country are examined and valued at the custom house. This system affords a fairly accurate record of the visible exports and imports of a country. A country's "invisible" foreign trade is so called because no such record is available owing to its nature. It consists of the import and export of services, of bonds, shares and other evidences of indebtedness and, not being the subject of government supervision, there is no certain method of ascertaining the amount and volume of these transactions. For that reason they can only be roughly estimated.

The disparity between the visible exports and the visible imports of the principal countries of the world for the year ending December 31, 1913, which represents normal trade conditions, will demonstrate the importance played by the invisible exports and the invisible imports in adjusting the balances of payments among the countries of the world.

	Imports	Exports
	(Last six ciphers omitted)	
Great Britain	$3,080	$2,371
Germany	2,545	2,132
United States	1,717	2,311
France	1,589	1,296
Austria	726	591
Canada	670	356
Russia	603	782
Denmark	215	156
Sweden	185	177
Netherlands	144	188
Norway	141	87

It will be noted that the imports of the above countries with the exception of those in the United States, Russia and the Netherlands, exceeded the "visible" exports; the difference was adjusted by "invisible" exports. Such excess of visible imports does not necessarily place a country at a disadvantage, for in the case of the older countries goods are imported to pay for services (such as freight and insurance) or to meet the interest on foreign investments. In the case of a young country like Canada, however, the excess of imports usually consists of goods purchased with money borrowed abroad for capital expenditure, such as material for railways, factories and public works.

3. *Origin and supply of foreign exchange.*—Altho the export and import of merchandise are the basic factors of international indebtedness, the other elements which must be taken into consideration have a precisely similar effect on the balances of indebted-

ness, and they can therefore be expressed in terms of exports and imports. Summarizing what has already been said, trade between two countries on the gold standard consists of mutual exchanges of:

1. Merchandise
2. Gold
3. Services
4. Evidences of indebtedness.

For the sake of simplicity we generally consider that one country, say, the United States, trades with another country, England, just as if a statement of account were made out daily and the relative balance arrived at and settled. Such, of course, is not the case; the transactions occur among a multitude of independent merchants and bankers, whose bills of exchange on one another furnish the supply of, and govern the demand for, foreign exchange, and thus affect the price of exchange between the two countries in question. Bankers and exchange brokers in New York and London encourage the public to utilize their services for paying debts abroad, and in order that they may do this, also encourage those who have claims against persons abroad to sell these claims to the banks in the form of bills of exchange, thus enabling the banks to offset sales against purchases. In other words, the banks are both buyers and sellers of foreign exchange. A continuous process of assembling and distributing exchange is thus effected thru the agency of banks, which act as clearing houses, and eventually make a settlement between the financial centers of the two countries. Should New York banks, for instance, be called upon for more exchange on London than they are able to buy, they must provide funds to meet their withdrawals by exporting gold or by some other means. As a rule, gold shipments are avoided as much as possible and the required balance in London is often created by:

1. Buying exchange on other centers and sending to London for credit.
2. Shipping securities to London to be sold or borrowed against.
3. Using finance bills.

While these expedients will receive detailed attention later a word or two of explanation may be in order at this point. In the trade between the United States and Canada, there is ordinarily a balance to be paid by the latter country. Before the war Canada was in the habit of discharging this obligation by drafts upon her largest customer, Great Britain.

When a similar recourse is not available resort is often had to stocks and bonds. There are a large number of such securities which are international in character, with as ready a sale in London as in New York. A transfer of such securities to the London market has the same effect as a shipment of gold. It can therefore be used to avoid such a shipment. Moreover the market for such securities is very sensitive. Slight variations in the exchange rate may make London or New York the better market for the sale of securities and will set in motion almost instantly a flow of securities from one market to the other.

Finance bills which are frequently used in the circumstances noted are more in the nature of a postponement than a settlement. They may be briefly described as a temporary expedient of sixty to ninety days currency, used principally between seasons to anticipate a favorable change in the exchange rates. Exports, it may be noted, especially cotton and wheat, are not uniformly distributed over the entire year. It will be readily understood therefore that exchange will normally be low at some seasons and high at others.

These are the principal methods resorted to in an endeavor to adjust an excess of imports over exports; if in spite of them the balance of payments remains adverse, gold is shipped.

4. *"The United States in account with the world."*—The exports of one country form the imports of another, and a study of the foreign trade of different countries will show that the component items of the exports and imports vary only in degree. Dean Joseph French Johnson in "Money and Currency" gives a statement of "The United States in Account with the World" (reproduced on page 35) the headings of which are comprehensive and self-explanatory and call for very little comment. The amounts of the various items under invisible exports and imports are, of course, only estimates.

The exports of merchandise exceed the imports for the typical year under consideration, as they did in 1913, and the difference was adjusted by the "invisible imports." The statement shows that gold was both exported and imported, indicating that in the course of the year it was found necessary at times to import gold to correct a falling rate and at other times to export gold to adjust a rising rate.

The invisible exports and imports can be considered under broader classifications as net balances offsetting the excess of visible exports, as shown in the following statement;

THE UNITED STATES IN ACCOUNT WITH THE WORLD

(In Millions of Dollars)

EXPORTS Which make the Supply of Foreign Exchange	Cr.	IMPORTS Which cause the Demand for Foreign Exchange	Dr.
Visible Exports:		*Visible Imports:*	
1. Merchandise	1502	1. Merchandise	1062
2. Gold	121	2. Gold	85
Invisible Exports:		*Invisible Imports:*	
3. Stocks and bonds bought in the U. S. by foreigners (arbitrage included)	500	3. Stocks and bonds bought in foreign markets by Americans (arbitrage included)	616
4. Other investments by foreigners in the U. S.	30	4. Other investments by Americans in foreign countries	20
5. Interest and dividends on foreign securities owned by Americans	15	5. Interest and dividends on American securities owned by foreigners	50
6. Profits by Americans on investments in foreign countries	10	6. Profits by foreigners from other investments in the U. S.	30
7. Reduction of American bank balances abroad	..	7. Increase of American bank balances abroad	5
8. Increase of foreign bank balances in the U. S.	..	8. Reduction of foreign bank balances in the U. S.	10
9. Foreign tourists in the U. S.	15	9. American tourists abroad	100
		9*a*. Americans living abroad and drawing incomes from the U. S.	65
10. Foreign embassies, consulates, etc., in the U. S.	3	10. American embassies, consulates, etc., abroad	3
11. Ocean freight paid to Americans by foreigners	..	11. Ocean freights paid by Americans to foreigners	100
Extraordinary:		*Extraordinary:*	
12. Indemnities, subsidies from foreigners, or sales of public property to foreigners	..	12. Payment to foreigners on account of indemnities, subsidies, purchases of public property, etc. (Panama Canal)	50
Total export credits	2196	Total import debits	2196

Excess of visible exports:

Merchandise	$440,000,000
Gold	36,000,000
Total excess of exports	$476,000,000

Excess of invisible exports:

Interest and Profits (5 and 6)	$ 55,000,000
Tourists and Embassies (9 and 10)	150,000,000
Ocean Freight (11)	100,000,000
Investments (3 and 4)	106,000,000
Special Transactions (12)	50,000,000
Balance due by Foreign Banks (7 and 8)	15,000,000
	$476,000,000

The above statement shows that the United States paid $305,000,000 in goods for interest and services, took over $156,000,000 in investments, and still had a credit balance of $15,000,000 in foreign banks.

5. *Significance of the elements in the balance.*—In the list which has been given there are certain elements whose importance is universally recognized and appreciated and which call for more extended consideration in subsequent chapters. First in importance are the exports and imports of merchandise, the backbone of all international trade relations. They are usually the dominant element in determining the exchange rate. Next come a group of relations which might be described as financial rather than commercial. These concern investments, permanent and temporary, and banking relations which form the subject matter of international finance and as important

modifying conditions must receive special considerations in a volume on international exchange.

The other elements listed tho they may run into millions of dollars are of minor importance. It is sufficient here to note their existence. Before the Great War American travel abroad and in a lesser degree the residence of American officials and citizens in foreign countries called for a steady supply of exchange in the form of letters of credit and traveler's checks. These in effect covered American purchases abroad and from the standpoint of international exchange it must be wholly immaterial whether those purchases and services were consumed where bought or whether they reached the United States in the form of imports. The restriction of travel during the war period and the months following the armistice checked this stream. During 1920, however, it began to flow again at a rate which had seldom been equalled before that year. Again, the United States, with its inadequate merchant marine, formerly paid heavy toll to foreign countries for freight, as practically all of her exports and imports were carried in foreign bottoms. Now, however, the situation has changed. A merchant marine has been created and if judiciously operated should relieve American trade of payments to foreign ship owners.

It is the combination therefore, of a wide variety of forces, some large and some small, which fixes the actual rates of exchange between nations. These must be the next subject for our consideration.

REVIEW

How does indebtedness between countries arise?

What are the invisible factors in the balance of international payments? What are the visible factors?

How is the balance of visible factors adjusted?

Describe Dean Johnson's statement of the United States in account with the world. What seems to be the relative importance of the different elements of the statement?

CHAPTER IV.

GOLD EXCHANGE RATES

1. *Gold standard.*—Before 1914 the leading commercial nations of the world had in fact as well as in law a gold standard of currency. Under a gold standard the money unit is a definite quantity of gold of a standard fineness which is represented in the coinage of the country by coins equalling the standard in value or multiples or subdivisions of the same.

It is not at all necessary to the existence of the gold standard that such coins should pass freely from hand to hand in the daily transactions of the people. In fact the greater part of the circulation of gold consists in the fact that it lies hidden in the vaults of the banks and in the coffers of the government as a guarantee for the value of other currency, chiefly paper. The essence of the gold standard then lies in the fact that for any of the uses for which metallic gold is required it can readily be obtained by presenting at the proper place an equivalent amount of other currency. In other words it is the ready convertibility of all forms of currency into gold which constitutes the gold standard.

One of the chief uses of metallic gold is to settle the balances of indebtedness to foreign countries in other words to regulate exchange relations.

2. *Gold exchange standard.*—There are a number of nations which have not been able to afford the luxury of the gold standard in the internal monetary circulation of the country, yet which use gold as a basis of exchange. The government fixes a definite relation between the actual currency of the country and gold, and it undertakes either directly or thru the banks to maintain this relation with gold in all dealings with foreign countries. To do this it must provide a stock of gold sufficient to meet necessary demands for foreign payments, while at the same time it takes such measures to maintain exchange rates as render those demands as small as possible.

Thus exchange thruout the greater part of the world was a few years ago conducted on a gold basis, and if we understand thoroly the factors entering into such exchange, the present, it is hoped, abnormal conditions of the exchange market will be the more readily comprehended.

3. *Monetary systems.*—For an understanding of the facts of foreign exchange an acquaintance with the leading monetary systems is indispensable. Each of these money units represents in theory at least a definite weight of pure gold. When theory and practice accorded the units of the chief commercial nations were as given in the following table.

Country	Name of Unit	Gross Weight Grains	Pure Gold Grains of	Dollar Equivalent	Sterling Equivalent in Pence
Austria-Hungary	kronen	5.22776	4.70498	.20262	.10d
Latin Union	franc	4.97817	4.48036	.19295	9.516
Canada and United States	dollar	25.8	23.22	1.	49.316
Denmark	kronor	6.91415	6.22274	.26799	13.212
Germany	reichsmark	6.14588	5.53134	.23821	11.75
Holland	gulden	10.37054	9.33348	.40195	19.82
Japan	yen	12.86024	11.57422	.49505	24.576
Mexico	peso	12.86023	11.57421	.49845	24.57
Russia	rubles	13.27584	11.94826	.51456	25.37
Great Britain	pound	123.27447	113.00160	4.86656 or 4.86 2/3	....

The divergence of fact from theory in the present disturbed state of the currency in most of these nations will engage our attention later. For the present we are concerned with rates of exchange on the gold basis of a few years ago. Since the weight of foreign coins is in most countries officially given in grammes a table has been prepared and presented as a folder opposite page 42 making a comparison of the leading and some other nations on this basis. The term Latin Union in this table embraces France, Italy, Belgium, Switzerland and Greece. This Union ceased to exist in 1920 but the name is retained here as the facts given pertain to an earlier period.

Those who have interested themselves in the project of an international coinage have pointed out, that with minor deviations there are in effect represented in this table not more than two distinct money systems based respectively upon the shilling (approximately 25 cents) and the franc (approximately 20 cents.)

This groups the franc and the Austrian krone with the Dutch gulden which is substantially the double franc. It groups Germany and Scandinavia together with Russia, Mexico and Japan having a double shilling. The dollar appears as the multiple alike of the shilling and the franc, while the pound sterling is of course, the multiple of the shilling as well as of the franc. It is not to be wondered that among those whose desire to remake the world is innate, these approximate relations should give rise to the dream of a pound that was exactly five times the dollar, and a dollar that should be exactly twice the yen and the rouble, two and a half times the gulden, four times the mark and five times the franc. Nor is there any doubt that if this could be brought about international financial relations would be greatly facilitated. Such approximate relations as now exist may be convenient for a rough and ready translation of one currency to another, but business is not done that way. It requires a more accurate calculation of these relations.

The theoretical relations of nations with another are regulated by the mint par. The actual relations are governed by the rates of exchange tempered by the cost of shipping gold. These three matters are intimately associated and should receive careful attention.

4. *Mint par of exchange.*—The mint par between any two countries is the value of the monetary unit of one country expressed in terms of the monetary unit of another country using the same metal as a

TABLE OF GOLD CONTENTS AND EQUIVALENT VALUES OF THE MONETARY UNITS OF THE PRINCIPAL GOLD STANDARD AND GOLD EXCHANGE STANDARD COUNTRIES.

Country:	Unit:	Value of $1:	Fineness:	Value in Dollars:	Value in Pence:	Grammes		Remarks:
						Standard:	Fine:	
Egypt	*£E*	*£E* 0.2023	875	$4.9429	243.733	8.500	7.4375	—
Turkey	*£T*	*£T* 0.2273	916⅔	4.3966	216.8	7.2164	6.615	—
Great Britain	Sovereign	49.316d	916⅔	4.86656	240.	7.988055	7.32238	$113\frac{1}{623}$ grains
Portugal	Escudo	*E* .9255	900	1.0805	53.284	1.80634	1.62571	—
Uruguay	Peso	*P* .9669	917	1.0342	51.003	1.69717	1.55615	No gold coins minted
Newfoundland	Dollar	$ .9863	916⅔	1.0139	50.	1.66420	1.52551	—
United States	Dollar	$ 1.	900	1.	49.316	1.671813	1.50463	23.22 grains
Argentina	Peso	*P* 1.0365	900	.96476	47.58	1.6129	1.45161	45/31 grammes
Brazil	Milreis	1$831	917	.54616	26.935	.89648	.82207	No gold coins minted
Brazil (*paper*)	Milreis	3$0822	916⅔	.32444	16.	.532537	.48816	1/15 of £1
Russia	Rouble	*R̄* 1.9434	900	.51457	25.371	.86026	.774234	—
Japan	Yen	*Y* 2.0062	900	.49846	24.582	.83333	.750	—
Netherlands, The	Florin or Guilder	*fl* 2.4878	900	.40196	19.823	.672	.6048	—
Costa Rica	Colon	*C* 2.1489	900	.46535	22.951	.77801	.7002	No gold coins minted
India	Rupee	*R* 3.1.1	916⅔	.32444	16.	.532537	.48816	1/15 of £1
Scandinavian Union	Krone	*Kr* 3.7315	900	.26799	13.216	.448023	.4032258	25/62 grammes
Germany	Mark	*M* 4.1979	900	.23821	11.748	.398248	.358423	100/279 grammes
Austria-Hungary	Krone	*Kr* 4.9352	900	.20263	9.993	.3387534	.304878	25/82 grammes
Latin Union	Franc	*Fcs* 5.18262	900	.19295	9.516	.3225806	.2903226	9/31 grammes

STATEMENT OF EQUIVALENT VALUES OF THE MONETARY UNITS OF VARIOUS COUNTRIES.

Country	Great Britain		North America	Holland	Scandinavian Union	Germany	Austria-Hungary	Latin Union
	Pounds	Pence	Dollars	Florins	Crowns	Marks	Crowns	Francs
Great Britain *£1. Stg.*	1.	240.	4.866,563	12.107,110	18.159,515	20.429,46	24.017,426	25.221,54
Portugal *Escudo*	.222,019	53.284,58	1.080,470	2.688,010	4.031,761	4.535,733	5.332,321	5.599,670
Uruguay *Peso*	.212,518	51.004,38	1.034,233	2.572,990	3.858,223	4.341,631	5.104,140	5.360,039
North America *Dollar*	.205,484	49.316,11	1.	2.487,816	3.731,485	4.197,922	4.935,192	5.182,621
Argentina *Peso*	.198,243	47.578,34	.964,762	2.400,152	3.600,000	4.050,000	4.761,288	5.000,000
Brazil *Milreis*	.112,228	26.934,77	.546,166	1.358,760	2.038,010	2.292,762	2.695,433	2.830,571
Russia *Rouble*	.105,735	25.371,24	.514,567	1.280,148	1.918,100	2.160,113	2.539,488	2.666,806
Japan *Yen*	.102,426	24.582,17	.498,461	1.240,079	1.860,000	2.092,500	2.460,000	2.583,333
Holland *Florin*	.082,596	19.823,04	.401,960	1.	1.499,904	1.687,392	1.983,744	2.083,200
Chili *Peso*	.075	18.	.364,992	.908,033	1.361,963	1.532,206	1,801,306	1.891,616
India (Br.) *Rupee*	.066,666	16.	.324,438	.807,141	1.210,634	1.361,963	1.601,161	1.681,436
Scandinavian Union *Crown*	.055,068	13.216,22	.267,990	.666,709	1.	1.125,000	1.322,581	1.388,889
Germany *Mark*	.048,949	11.747,736	.238,213	.592,630	.888,889	1.	1.175,627	1.234,568
Austria-Hung'y *Crown*	.041,636	9.992,76	.202,626	.504,097	.756,097	.850,610	1.	1.050,136
Latin Union *Franc*	.039,649	9.515,69	.192,953	.480,030	.720,000	.810,000	.952,258	1.

Calculations based on 15.432,35 grains to the gramme.

standard of value, tho the degree of fineness of the metal need not be the same. All coins, whether of gold or silver, are made of so much pure metal and so much alloy; the latter is used to harden the coins, thus reducing abrasion to a minimum. The term "fineness" expresses the number of parts of pure gold or pure silver contained in a thousand parts of the combination. The British sovereign is 916 2-3 parts fine, or 11 parts fine gold and one part alloy. The gold coins of Turkey and Brazil are also 916 2-3 fine. Those of nearly all other countries are on a basis of 900 fine, or 9/10 fine gold and 1/10 alloy.

The mint par is arrived at by dividing the number of grains or grammes of fine gold in the one coin into the number contained in the other. For instance, compare the sovereign, the unit of Great Britain, and the gold dollar, the unit of the United States:

Gross weight of sovereign	123.27447 grs.
Less $^{1}/_{12}$ alloy	10.27287 grs.
Fine gold in sovereign	113.00160 grs.
Gross weight of dollar	25.8 grs.
Less $^{1}/_{10}$ alloy	2.58 grs.
Fine gold in dollar	23.22 grs.

therefore,

$$1 \quad \text{dollar} = \frac{23.22}{113.0016} = \pounds.205484 = 49.316 \text{ pence}$$

$$1 \text{ sovereign} = \frac{113.0016}{23.22} = \$4.86656$$

Similarly, the gold franc contains .2903225 grammes of fine gold, while the dollar contains 1.50463 grammes. Hence,

$$1 \text{ dollar} = \frac{1.50463}{.2903225} = 5.18262 \text{ fcs.}$$

$$1 \text{ franc} = \frac{.2903225}{1.50463} = 19.2953 \text{ cents}$$

The mint par between any two countries can be arrived at in the same way. The mint par between two gold using countries is constant. It varies only when one of them alters its coinage regulations by increasing or decreasing the quantity of pure metal in its monetary unit.

5. *Par of exchange.*—The mint par is the pivotal point of the rates of exchange between two countries. In other words, it is also the ratio at which the standard coin of the country will be exchanged for that of another. Theoretically, a sovereign is worth par in New York ($4.86656), but practically this ratio holds good only for large amounts. If a traveler wants to change ten sovereigns in New York he would probably receive only $48.50 or $48.60 for them instead of $48.66 2/3, the difference between retained by the bank as payment for its services and to cover the interest on the amount until it had collected sufficient sovereigns, say, one thousand, to warrant the trouble of taking them to the United States mint where they would be exchanged for $4,866.56, less a small melting charge. If a few years ago the ten sovereigns were in London to the traveler's credit and this fact was properly attested he would probably have realized on them by selling to a New York bank the "right," in the form of a check or order, to draw these ten sov-

ereigns in London, and the New York bank would have paid him their equivalent computed according to the current rate of exchange. With an active demand for sterling exchange the seller would have obtained a good price for his check on London. If, on the other hand, there were little or no demand for sterling exchange and the supply of checks and bills of exchange was more than ample to meet the demand he would have obtained a low price.

It has already been pointed out that the mint par is merely the standard by which actual exchange rates are measured. They vary within narrow limits, fixed by the "gold points" or the cost of shipping gold. Exchange rates find concrete expression in the prices which prevail in the sale and purchase of bills of exchange.

6. *Rates of exchange.*—Bills of exchange are a commodity and as such are bought and sold, and like other commodities are subject to the law of supply and demand. The reader should, for the present, dismiss from his mind the thought that he is dealing in the money of foreign countries and should regard bills of exchange and other credit instruments, used in transferring funds, as representing a definite kind of commodity—evidences of indebtedness.

The rate of exchange is the price per foreign unit at which the right to collect these debts is sold and it does not refer, except indirectly, to the value of the gold monetary unit. A sovereign is always worth par in New York and the gold eagle always worth par in London. When gold sterling is quoted at, say, $4.85 in New York it does not mean that the sovereign has depreciated 1 2-3 cents below par; it means that the "right" to obtain a sovereign in London is worth only $4.85 in New York. In this case the supply of these "rights" is ample and the demand small, hence the price falls.

7. *What makes the rate.*—The rates of exchange quoted between any two countries, therefore, are the prices for checks and bills of exchange. These are the mediums by which debts are transferred from one party to another.

The rate of exchange between two gold using countries charged by a bank or broker for a foreign bill of exchange includes:

1. The mint par or price equivalent of the foreign coin.
2. Plus or minus a premium or discount on the mint par (greater or less conversely to the supply of bills on the market as compared with the demand for them).
3. Plus a premium or commission which the banker demands for his trouble and for the economy and superior convenience of a draft as compared with a remittance in coin or bullion.
4. Less an allowance for interest, according to the distance between the two points, and the tenor of the draft.
5. Plus the cost of shipping gold.

The rate of exchange paid by a bank or broker for a foreign bill of exchange includes:

1. The mint par.
2. Plus or minus a premium or discount on the mint par.
3. Less a commission covering the dealer's profit and an allowance for his risk and trouble.

4. Less a discount, according to the tenor of the draft.
5. Minus the cost of shipping gold.

The mint par never varies. It is a constant factor in any exchange rate. The most frequent variations in the rates are found in the premium or discount on the mint par, the range of which is governed by the law of supply and demand, and reflects the relative position of two countries as regards indebtedness. The allowance for interest or discount generally tends to vary with the foreign interest rate, tho sometimes in large transactions the domestic interest rate becomes a factor also, in connection with the financial operations necessary to complete them. The cost of shipping gold is modified and at times offset by the mutations in the other factors.

8. *Coinage ratio.*—The rate of exchange, therefore, must not be confused with the ratio at which one country will exchange its money for the standard coins of another country. If a man has one thousand sovereigns in New York he will receive par for them, or $4,866.56 [1] irrespective of the rate of exchange.

9. *Fluctuation in the rate of exchange.*—The in-

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[1] The United States Mint will always pay for English sovereigns at the rate of $18.949182 per ounce. 1,000 sovereigns weigh 123,247.47 grains (480 grains to the ounce Troy). Working this out, we get $4,866.56 as the value of 1,000 sovereigns. As a matter of fact the United States Mint would pay the bank 90 per cent of this amount ($4,380) on delivery and the balance ten days later, less a small charge of four cents per $100 to cover melting expenses, thus the actual proceeds would be $4,864.61.

Similarly the British Mint took gold eagles at £3:16:5½ per ounce, paying for them a fortnight after delivery without any charge. The Bank of England paid for them on delivery but made a small charge of about 1½d. per ounce to cover the interest for 14 days at 4 per cent.

termediate rates between the gold points and the mint par, that is, the rates at which business is usually done, in addition to being affected by the supply and demand of bills between two places, rise and fall in sympathy with the influences at work on the other exchanges. London, for instance, while a debtor to New York, might be a creditor of Denmark, France or another country with which England has close exchange relations. If London drafts on these places were remitted to New York they would improve (i.e. raise) the rate of sterling exchange for the time being. If, however, the supply both of New York and Continental bills were to fall short, the point at which London would have to export gold would be soon reached.

10. *Rates tend to correspond.*—The rates of exchange between two or more places either correspond or tend to correspond. Thus, when a few years ago sterling exchange was at a discount in New York, say, at $4.85, New York funds in London were at a premium; in other words, you could purchase in New York the right to obtain a sovereign in London for $4.85, whereas for a sovereign in London you would only be able to obtain the right to $4.85 in New York, a dollar costing 49.50d. instead of 49.316d., the par value.

Let us suppose that the rate in New York, in response to a demand for sterling, suddenly went to par, and a New York banker having heard from his London correspondent that New York funds were still at

$4.85, cabled him to sell $100,000 at that rate and as a result of this transaction the New York banker received a credit in London of £20,618.55. At the same time he sold his own draft at par against this amount in London. In actual practice he would have sold a draft of, say, £20,000, but for the sake of showing his profit let us presume that he sold a draft for £20,618.55. For this he received $100,343.64 with which he paid the draft of $100,000 drawn on him in London, and thus makes a profit of $343.64 less cable charges and a small commission to the London banker.

By such processes the exchanges automatically regulate themselves between two or more places. It is obvious that under the influence of several such transactions marginal differences would rapidly disappear. The variations in the rates of exchange in the case cited are purposely exaggerated for the sake of illustration. In practice, a very slight difference in the rates will encourage these adjusting transactions, which are commonly known as arbitrage transactions.

11. *Gold points.*—Foreign exchange, thru the medium of bills of exchange and other credit instruments, enables countries to regulate their mutual indebtedness without the transfer of coin or bullion. A bill of exchange is a commodity like wheat and cotton, and, as such, it is subject to the law of supply and demand. If the purchase rate of exchange reaches the point at which it is cheaper to remit gold

than to pay the rate demanded for transfer by draft, gold exports usually result. The rates of exchange, produced by buying gold in one country and shipping it to another, are called the *gold or specie points.* The mint or theoretical par remains invariable among gold standard countries. If the exporting and importing of gold could be effected without expense or loss of interest, the mint par and gold points between any two countries would be practically identical, but heavy expenses for freight, insurance, cooperage, cartage, abrasion, interest while in transit and other charges are involved in a gold shipment. These expenses deducted from the mint par give the "import gold point" and added to the mint par give the "export gold point;" that is to say, if it should cost more to buy gold sterling exchange in New York than it would cost to buy gold to the same amount and ship it to London, the remitter naturally would take the cheaper method and export gold. On the other hand, when bills of exchange are so freely offered in New York that the rate becomes abnormally low, a seller, if he could obtain gold at par in London for his pounds there, would find it cheaper to transfer his London balance by importing the gold.

Under normal conditions, the cost of shipping sovereigns between London and New York is about two cents per sovereign, and the mint par of the pound sterling is $4.86 2-3. Therefore, when a lower price than $4.84½ was a few years ago offered for a bill of exchange it was cheaper to import the gold from

England, and when a higher price than \$4.88½ was asked, it was cheaper to send gold to England.

12. *Significance of gold movements.*—The export of gold from New York to London when gold is readily available in exchange for currency in both countries implies:

1. That New York owes London (exchange is favorable to London and unfavorable to New York).

2. That bills of exchange on London have been eagerly sought for in New York in order to liquidate this indebtedness.

3. That the premium demanded by sellers in the form of a higher exchange rate exceeds two cents per pound sterling and therefore it has become cheaper to buy gold in New York and export it to London.

Conversely, the import of gold to New York from London implies:

1. That London owes New York (exchange is favorable to New York and unfavorable to London).

2. That bills of exchange on London have been offered freely in New York to absorb this balance.

3. That the discount demanded by buyers in the form of a lower exchange rate exceeds two cents per pound sterling and therefore it has become cheaper to buy gold in London and import it to New York.

13. *Actual gold points.*—Before the war, when all the countries concerned were on a gold basis, the extreme range of the gold points between New York and London, and the continental centers was approximately as follows:

	Imports	Par	Exports
New York and London....	$ 4.84½	$4.86 2/3	$4.88½ per £1.
New York and Paris......	5.23	5.18⅛	5.16 fcs. per $1.
New York and Berlin.....	94.50	.95⅛	96.25 cents per 4 marks
London and Paris.........	25.32½	25.22	25.12½ fcs. per £1.
London and Berlin........	20.53	20.43	20.34 mks. per £1.
London and Amsterdam...	12.15	12.10	12.04 florins per £1.

14. *Computing the gold point.*—Gold points are determined by the actual costs of shipping gold from one country to another and of making it available for monetary use in the country to which it is sent.

The charges for freight and insurance are readily comprehended. They have been in the last two decades fairly uniform and with improvements in transportation have tended to grow less. They may vary with unusual circumstances, as when the war forced all transportation and insurance charges upward. In August, 1914, for example, the United States could have shipped gold to Europe, only at great expense. In order to provide the necessary payments an arrangement was made by which gold was shipped to Ottawa, the Bank of England accepting payments in London on New York account against this deposit.

Another element is the charge for interest while the gold is in transit. This depends upon the rate of interest and the duration of transit. The improvement of ocean shipping has considerably diminished this charge. If as is generally the case the rate of interest in New York is higher than in London it would cost more to ship a given quantity of gold from New York to London than in the contrary direction. This among other things explains why the upper and lower "gold points" are not as a rule equidistant from the mint par of exchange.

The more easily the foreign gold is made available for monetary use in the country in which it is received the smaller will be the divergence of the gold point from the mint par. Any obstructions placed upon this transfer will increase the divergence. Let us suppose for example, that all banks are under strict government supervision and are allowed to hold only domestic gold coin as reserve. The foreign gold must then be transformed into domestic coin before it can be used for monetary purposes. Coinage may be gratuitous, in which case there is no added expense except the loss of interest during the delay of manufacture into coin. This is added under such circumstances to the cost of shipping gold to that country. If, as not infrequently happens, there is a small charge say one fourth of one per cent to cover the costs of coinage, this too must be added to the cost of shipping gold.

15. *Gold shipments from New York.*—The following description of a shipment of $1,000,000 in gold from New York to London is taken from Dean Joseph French Johnson's "Money and Currency" and will serve as an example of how a shipment of gold was made under normal conditions and will illustrate the many small factors which enter into the computation of costs.

During the last quarter of the nineteenth century the cost of shipping gold from New York to London fell from three to two cents per pound sterling. The charges for freight and insurance both declined, while the increased speed of transatlantic liners reduced the loss on account of interest.

The following figures, showing the cost of shipping $1,000,000 in gold from New York to London, were furnished by the representative of one of the largest New York banking houses:

Invested in fine bars, 23,220,000 gr. (48,375 oz.)	$1,000,000.00
Assay office premium on bars, 4 cents per $100	400.00
Freight, 5/32 per cent	1,562.50
Insurance, 1/16 per cent	625.00
Packing and cartage	70.00
Total outlay	$1,002,657.50

The Bank of England's "price" of gold varies from 77s. 9½d. to 77s. 10½d. per ounce, English standard, 916⅔ fine. The mint coins an ounce of gold, English standard, into 77s. 10½d.; but the Bank of England, with which it is the custom of bullion owners to deal, usually pays a fraction less than this sum, thus saving itself from loss of interest while the bullion is being coined. It is assumed below that the bank pays 77s. 10d. per ounce.

48,375 oz. fine = 52,772.7 oz., 916 2/3 fine.

52,772.7 oz. @ 77s. 10d.	£205,374
Deduct sundry expenses	4
Net receipts in London	£205,370
Cost of sovereign (1,092,657.50 ÷ 205,370)	$4.8822
Mint par in United States	4.8665
Cost of shipment per sovereign	$ .0157

The reader will notice that no loss on account of interest is included in the foregoing. The New York banker who furnished the figures held that no such item was involved, for he sold sterling exchange as soon as he made a shipment, and so was never out of money in consequence. If we include interest for ten days at three per cent ($835.54) we raise the cost of the shipment to $.0197 per sovereign.

16. *Avoiding gold shipments.*—The principal object of exchange transactions is to avoid the transfer of money from place to place and the machinery of exchange operations is largely directed to that end. The early days of the war with the increased risk and expense of transferring gold, gave rise to various expedients which may in modified form be adapted to peace conditions. The usual method was to deposit gold in the debtor country for account of the creditor country.

A part of the reserve gold of the Federal Reserve banks found safe repository for many months in the vaults of the Bank of England. The Bank of England accepted gold in Ottawa as equivalent to a shipment of gold to London. The Argentine Republic, Japan and other countries had gold deposited for their account in New York and London. Some more definite agreement along such lines among the financial interests seems to be a not unlikely future development which will avoid still further the costs of shipping gold.

17. *Reading the exchange rates.*—Within the limits fixed under normal conditions by the gold points, exchange varies. Unless a man is directly concerned in the business of foreign exchange the interpretation of the exchange rates published in the papers usually escapes him. Few men are familiar with the mint par of exchange which is the basis on which actual rates are judged, and these parities are not always given when actual rates are quoted.

There are two ways in which exchange can be quoted, fixed and movable exchange. When exchange is fixed the foreign unit is expressed in terms of the domestic unit. Thus, for example, if the price of a pound sterling were quoted at $4.87 it would mean that this sum must be paid for each pound and that exchange would be above par. When on the other hand exchange is movable its price represents the amount of foreign money which can be purchased for a given quantity of domestic money. Thus before the war the exchange quotations on francs meant the number of francs which could be purchased for $1.00. The par was 5.18 1/8 francs. If exchange was quoted at say 5.10 francs, exchange was at a premium; if it rose to 5.25 exchange was at a discount. In other words in fixed exchange the rise or fall of the quoted price varies directly with the premium or discount, but in movable exchange the rise or fall of the quoted price is inversely as the premium or discount.

18. *Exchange quotations.*—The newspapers generally give exchange quotations in two columns. The first column (b) gives the price offered by buyers, and the other (s) gives the sellers' price; one expressing the demand and the other the supply. The first column gives the lowest quotations—the buyers naturally offer as low a price as possible, while the sellers try to obtain the highest price—but the real or trading quotation is generally somewhere between the two. There are two classes of quotations; the

posted rate, which is used principally for small amounts, and the actual or wholesale rate, used between bankers and brokers for large transactions. As a rule, however, the rate for very large transactions is a matter of individual negotiations owing to the frequent change in conditions during the day. Furthermore, the rates are seldom announced in time to be of much use except to show the general trend of exchange.

The American method of quoting dollars and cents per foreign unit (fixed exchange) is so simple that it renders exchange quotations self-explanatory. Canadian foreign exchange quotations are governed by the New York exchange market and differ only to the extent of the premium or discount on New York funds in Canada.

Quotations given by the press lack uniformity. The method adopted by the Federal Reserve Bulletin of quoting per hundred units has advantages, as it not only permits fine shading if necessary, but can be read either as the dollar value of one hundred units or the cent value of one unit.

At the beginning of 1920 a successful campaign was started in New York by some of the members of the Foreign Exchange Club with the object of placing French and German quotations on the same basis as those of other countries. This marks the beginning of a movement on the part of the leading New York banks and exchange brokers to simplify exchange procedure, which will go far to dispel some of the mystery which has hitherto been unnecessarily thrown around exchange transactions.

In the whole range of business mathematics nothing more confusing or awkward can be found than the former franc quotation. It was the only movable exchange rate among the quotations. It fluctuated by five-eighths of a centime and close quotations were based on the subtraction or addition of sixty-fourths of 1 per cent on the dollar amount. There was nothing scientific or practical about this method, and it merely enabled some unscrupulous dealers to take advantage of the uninitiated public. People who dealt only occasionally in French exchange were prone to overlook the rule "Buy high, sell low," and unconsciously compared competitive rates on the basis of fixed exchange. "Buy low, sell high, the better the bill, the higher the rate."

A broker for instance who offers to sell a draft on Paris for Fcs 10,000 at 5.18¾ would in many cases obtain the business against a quotation of 5.19⅜. The latter price looks the higher to the customer, but it is of course the better quotation by $2.32 in this particular transaction. If the same customer were selling francs he would, with the same reasoning, prefer to sell at 5.19⅜.

19. *Range of quotations.*—A study of the normal equivalents of foreign units in the following table shows an almost steady progression in value from about 18 cents to 53 cents, with only one exception, sterling with its larger unit worth $4.866. Sterling

quotations range from 4.75 to 4.90, advancing by 5/100 of a cent per pound, or as it is called 5 points per pound. The other quotations advance by steps of .01 cent, or one cent per 100 units, thus 18.01, 18.02, 18.06 and so on. The last column shows the profit made on $1,000 for every advance of .01 cent, the profit on 1,000 foreign units being, of course, 10 cents for each advance of .01 cent in the quotation.[1]

Country	Unit	Par Value in Dollars	Ordinary Range	Profit per $1,000
Latin Union	Franc	.193	18 to 20 cents	51.8 cents
Austria-Hungary	Crown	.203	20 to 22 “	49.2 “
Germany	Mark	.238	22 to 25 “	42. “
Scandinavian U.	Crown	.263	26 to 28 “	37.3 “
Holland	Florin	.402	39 to 41 “	24.9 “
Mexico	Silver Dollar	fluctuating	41 to 50 “	22. “
South America				
Asia				
Japan	Yen	.498	50 to 53 “	19. “
Russia	Rouble	.515	50 to 53 “	10. “
Great Britain	Pound	4.866	4.75 to 4.90	02. “

20. *Fixed and movable exchange.*—When foreign exchange is quoted in the home currency per foreign unit, it is called fixed exchange; for instance, exchange on London is quoted in New York in dollars and cents per pound sterling. The latter is the fixed basis. The value of the pound fluctuates in dollars and cents—the higher the quotation the higher the cost of the foreign unit.

When the rate is quoted in foreign currency per home unit it is called movable exchange; for instance, exchange on Paris is quoted in London in francs and centimes per pound. The fluctuation is expressed in the foreign currency—the higher the quotation the lower the cost of the foreign unit.

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[1] The best tables for general use are to be found in “Foreign Exchange Tables” by E. D. Davis, Minneapolis, and “Foreign Exchange Explained and Simplified” by Howard K. Brooks, Chicago. Both of these books cover the whole range of the foreign exchanges. For sterling, Hartfield's “Sterling Conversion Tables” is the most comprehensive.

The United States and Canada quote in fixed exchange (dollars and cents per foreign unit) tho for large transactions with France and some other countries movable exchange was formerly used almost exclusively. A homely illustration may make the difference between those two methods of quoting clearer. Sugar and other commodities, like fixed exchange, are sold at so many cents per pound, or per hundred pounds, and the higher the price quoted the less sugar (or foreign money) you will receive for a dollar and therefore the dearer the exchange.

Sugar, like movable exchange, is also sold at so many pounds for the dollar (as was the case with French exchange) and the more sugar (or francs) quoted for a dollar the cheaper the exchange.

Fixed exchange: cents per foreign unit. Rule, buy low, sell high, the better the bill the higher the rate.

Movable exchange: francs per dollar. Rule, buy high, sell low, the better the bill the lower the rate.

Rule for fixed exchange.—Buy low, sell high, the lower the rate the more foreign money received. The better the bill the higher the rate.

How many francs can be bought for $1,000 when the rate is 19.3 cents per franc?

$\$1,000 \div 19.3 =$ Fcs 5181.35.

How much will drafts for the following named amounts cost?

Fcs 5181.35 at 19.35 cents $= 5181.35 \times 19.3 = \$1,000$.

Mks 4,000 at 24 cents $= 4,000 \times .24 = \$960$.

Rule for movable exchange.—Buy high, sell low, the higher the rate the more foreign money received per dollar. The better the bill the lower the rate.

How many francs can be bought for $900 when the rate is 5.16⅞ per dollar?

$5.16875 \times 900 =$ Fcs 4651.87.

What is the value of a draft on Paris for Fcs 5,000 when the rate is Fcs 5.16⅞ per dollar?

$5{,}000 \div 5.16875 = 967.35$.

21. *Premium and discount.*—Those countries which are fortunate enough to have a monetary unit of the same weight and fineness in gold have no conversions to make, and do not require any exchange tables. Among these countries are the United States and Canada with the dollar in common, Great Britain and her colonies with the pound sterling, and the European countries with the franc or its equivalent. Fluctuations in exchange rates in these countries are quoted at either so much per cent discount or premium, or, as in the case of London and Australia, so many units per so many units, as £98 for £100. In the former case, where the percentage is small under normal conditions, these rates correspond exactly, a premium in one country corresponding to the discount in the other country or vice versa. As the percentage in premium increases however, it is necessary to allow for a difference which becomes very marked as the rate increases. In the case of the United States and Canada, for instance, the normal range of the exchange does not exceed 1/16 of 1 per cent, and a premium on New York funds in Canada of 1/16 would mean that Canadian funds in New York would

be at 1/16 discount. The corresponding discount of a premium of ¼ of 1 per cent, or twenty-five cents a hundred, would be .24936 per cent. Two per cent premium would correspond to a discount of 1.96078 per cent and 15 per cent premium to a discount of 13.04348 per cent. In other words 100 Canadian dollars in the United States would be worth 86.95652, and not, as might be supposed, $85.[1]

In these days of abnormal quotations the neglect to understand thoroly the above conditions may lead to loss in exchange transactions.

22. *Exchange tables.*—Exchange tables, like interest tables, are most convenient and useful tools, and tho formidable in appearance with their serried columns of figures, they are simple in operation and their compilation is merely a matter of multiplication. A book of exchange tables is really nothing more than a table of reciprocals and their multiples.

All exchange tables give the same information tho some give it in greater detail than others—the number of foreign units for so many dollars and the number of dollars for so many foreign units, at various rates. As an example, we will compile a brief franc table for

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[1] The above can be put in the form of a problem. If you obtain 100 United States dollars for 115 Canadian, how much do 100 Canadian dollars cost? This resolves itself into the proportion sum.

$$115 : 100 :: 100 : X \frac{100 \times 100}{115} = 86.96$$

or a discount of 13.04%.

A card compiled by Mr. Patterson, giving the premium and discount parities per $100, is published by John W. Hartfield, Inc., New York.

the rate 19.24. This represents the value of a franc in cents and we must now find the value of one dollar by division, $\frac{1}{19.24}$ = 5.1975 Fcs. We are now ready to compile our table as follows:

	Rate 19.24 cents *Francs per Dollars*	*Dollars per Francs*
100	519.75052	19.24000
200	1,039.5010	38.48000
300	1,559.2516	57.72000
400	2,079.0021	76.96000
500	2,598.7526	96.20000
600	3,118.5031	115.44000
700	3,638.2536	134.68000
800	4,158.0042	153.92000
900	4,677.7547	173.16000

Suppose we wish to find the value of 5642 francs at the rate 19.24 cents to the franc. The operation becomes one of addition:

5000 francs =	$962.000
600 francs =	115.440
40 francs =	7.96
2 francs =	.3848
	$1085.7848

To obtain the value of $5642 the process would be similar. Using the other column:

$5,000 = 25,987.526 francs, etc., etc.

By continued multiplication of the top lines, this table can be extended indefinitely, but the above is sufficient to find the equivalent of any sum up to 1,000,000 francs or dollars.

Our next table would be at the rate of 19.25, and so on for every quotation that is likely to be required.

REVIEW

Explain what is meant by the gold standard of currency.

What is the mint par of exchange?

Explain the meaning of fluctuations of the actual rates of exchange from the mint par.

What determines the rates?

Why do rates of exchange tend to correspond?

What are the gold points? What is their significance and how are they computed?

How is exchange quoted? How do rates in fixed exchange differ from those in movable exchange?

What are exchange tables?

CHAPTER V

EXPORTS AND IMPORTS

1. *Payments for exports.*—As we have seen, the movement of merchandise is not the exclusive factor in the commercial relations of nations, which give rise to transactions in foreign exchange but it is none the less the dominant element in the balance which has been studied. The transactions to which this merchandise movement gives rise are therefore worthy of especial attention. In the adjustment of commercial accounts, bills of exchange are drawn with documents attached. The chief of these documents is the bill of lading to which the others, consular certificates, insurance certificate and letter of hypothecation[1] are subsidiary. The nature of these documents needs no detailed explanation here, as the form and purpose of most of them have been fully explained in the Modern Business Text on "Foreign Trade and Shipping."

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[1] A letter of hypothecation is a certificate attached to a documentary bill of exchange and signed by the drawer. It describes the nature of the shipment, etc., and states in effect (1) that the bill of lading is lodged as collateral security for the acceptance and payment of the draft; (2) that in case of dishonor the holder is authorized to dispose of the goods and apply the proceeds toward payment of the draft and the expenses incurred; (3) that the drawer holds himself liable for any deficiency, and agrees to pay same on demand. When an exporter sells a number of bills of exchange to a bank, a general, or blanket, hypothecation certificate is given to apply to any and all bills of exchange purchased from him.

The method of using the commercial bill of exchange can be most conveniently explained by means of a concrete example. Suppose a cotton merchant in New Orleans had sold a quantity of cotton to a Liverpool firm against draft with documents attached. The merchant would draw a sixty days draft in duplicate for the amount of the invoiced goods, say £10,000, and take it, with the relative documents attached, to his banker in New Orleans, who would credit him with $48,500 at the rate of the day which we will assume to have been $4.85. The merchant would have sold his cotton, received his money and would be ready for a new transaction.

The New Orleans bank sent the original bill and documents to its London correspondent, the duplicates following by a subsequent steamer. What happened in London to the bill depends upon its nature and whether the documents were to be surrendered on payment or on acceptance. If the documents were to be delivered on acceptance, the bill would become a "clean" bill and could be discounted in the London discount market and the proceeds placed to the credit of the New Orleans bank. If the documents were deliverable on payment only, acceptance of the bill would be obtained, but the documents would remain attached to the bill until maturity, unless the acceptor took up the draft under a rebate of interest for the unexpired time.

In the case of an "acceptance" bill, the proceeds became available as soon as the bill could be accepted and discounted. In the case of a "payment" bill the American banker could not count on having the amount available until the maturity of the bill, tho prepayment under rebate might have placed the funds to his credit long before that time. If the New Orleans bank had no London correspondent it would have sold the draft to its New York correspondent, who would remit it to London in due course. All obligations on such bills remain liable until payment.

2. *The place of the transaction.*—Paradoxical as it may seem it makes a considerable difference whether an American exporter sells in a foreign market or a foreign importer buys in the American market. In both cases an export of American goods follows, and in both cases there must be a payment from the foreign country to the United States. The difference arises from the fact that in the first instance the American merchant obtains a foreign price for his wares, that is one fixed in a foreign market and expressed in foreign money, while in the second case he obtains an American price fixed by his own market and expressed in dollars. The first case puts the burden, if any, of exchange fluctuations upon the seller, the second puts it on the buyer.

In the illustration given in the preceding paragraph, the price was fixed in London and this is the usual rule in the sale of cotton. Where the price is fixed depends in large measure on the higgling of the market, in other words on whether the seller is more anxious to sell than the buyer is to buy or the contrary.

When the United States exported wheat before the war it had to adjust its prices to the world's markets, and wheat sold abroad was sold at a foreign price. The United States competed with other wheat producing countries in those world markets. But during the Great War we might say that the markets came to the United States and foreign demand competed directly with domestic demand. The enormous demand of the Allies for food stuffs had to be satisfied almost wholly by the United States and the nations of the world bought in American markets and paid American prices for what they bought.

Altho every shipment of goods to a foreign country involves foreign exchange the exporter need know nothing of the intricacies of the latter if payments are made in his own money. If he gets the price agreed upon he can afford to leave to his customer any consideration of how the money is brought together. It will readily be seen that transactions with foreign countries are greatly facilitated when exporter and importer deal in the terms of money with which they are familiar and in amounts that are perfectly definite.

Ten years ago London's ascendency in the trade and finance of the world gave it this transcendent advantage over all competitors. It enjoyed this position by virtue of the fact that it was the center of the world's commerce, and it had acquired that position largely thru the fact that for generations it had maintained the integrity of its monetary system. While other currencies may have fluctuated in value the world knew that a given number of pounds sterling always meant the same weight of pure gold. The war has shaken the supremacy of London by bringing an inconvertible paper money in its train. The impairment of the currency is less and its fluctuations less violent than in the Continental countries and the trade position of Great Britain compared with them has not changed. But in competition with the United States where the gold standard has been maintained Britain labors at present under disadvantages.

America is less disposed than formerly to clear its foreign exchange transactions thru London. It demands more and more that they be settled in New York. That means that in the trade of the world the dollar is taking in part the place long occupied by the pound sterling, and that international obligations whether they are those of foreign governments or those of foreign traders are more frequently expressed in dollars than was formerly the case. Let us examine how this dollar exchange affects the payments made for American exports.

3. *Financing foreign exports by means of dollar credits.*—Many goods are exported against dollar credits opened with some New York bank, and the exporter has a simple dollar transaction on his hands. Since 1916 dollar credits have issued in greater volume than ever before and will no doubt continue to be more largely used.

In the first instance the effort to establish dollar exchange was due to the desire to give trade with foreign countries as nearly the aspects of a domestic transaction as possible. The bankers of the United States have for a number of years been seeking to establish connections in foreign countries notably in South America with a view to familiarizing foreign dealers with dollar exchange. All these efforts have been immensely stimulated by the war which threw foreign currencies into disorder.

The primary motive in establishing dollar credits and dollar transactions has been to avoid loss thru fluctuating exchange with foreign countries. Let us consider the case of an American exporter, say, Mr. Brown of Baltimore who has sold a bill of goods to a customer in Paris.

He advises the purchaser to arrange a credit in New York in dollars for the amount of the invoiced goods, to be paid on delivery of the bill of lading and relative documents. The buyer goes to his banker, specifies the amount and the terms of the credit required, and the banker writes or cables to his New York correspondent to open a credit for so many dollars in favor of Brown. In this credit are set forth the terms in which Brown is to be allowed to draw the money, and the various documents which are to accompany the drafts. In due course Brown is notified that the credit has been opened. Accordingly, he draws a draft on New York and deposits it in his local bank. The draft is paid within a few days and, as far as Brown is concerned, the transaction is closed.

The New York bank having paid the draft and taken over the documents forwards them, debiting its Paris correspondent who opened the credit. If the customer of the Paris bank is of high financial standing the bank will probably turn over the documents to him at once, even before full payment is made. Otherwise the goods will be stored by the bank on their arrival and released when payment is received. This is purely a matter of arrangement between the Paris bank and its customer and does not concern the American exporter or banks. In pre-war days the Paris bank might have been unable to arrange a dollar credit on New York and so issued instead, a credit on London in pounds sterling against either time or demand drafts with documents attached. In either case the effect is to make the matter of granting credit one between the purchaser and the Paris bank, rather than between purchaser and seller. This relieves Mr. Brown of any anxiety as to the payment. But in the first case he draws against a dollar credit in New York which is a simpler operation involving less cost than drawing against a pounds sterling credit in London.

4. *Dollar acceptances.*—Until the establishment of the Federal Reserve banks, American foreign trade had been financed chiefly thru the medium of letters of credit issued on London banks. Establishing a credit in London, and thereby providing an English

acceptance, was no reflection on the high standing of the New York banks; it was due to provisions of the National Bank Act, which prohibited national banks from doing an acceptance business. Furthermore, the absence of an open discount market in New York was another serious obstacle to the free movement of foreign credit. This inability to finance foreign trade, except thru London, was formerly a serious handicap to the United States in its exchange relations with other countries. Spain, for instance, could never settle in dollars for imports from the United States because her imports from that country were paid for by credits opened in London, and these in turn had to be utilized to pay for credits opened in London in favor of the United States.

Mr. Lawrence Merton Jacobs in "Bank Acceptances"[1] referred ten years ago to this feature as follows:

> As a result of the inability of our banks to finance imports thru the acceptance of time bills, American importers are, then, made dependent to a large extent upon London, and are required to pay London a considerable annual tribute in the way of acceptance commissions. This practice not only adds to the importance of London and militates against the development of New York as a financial center, but it at the same time works serious injury to our export trade. Since time bills cannot be drawn on our banks from foreign points against shipments of goods to the United States, there are consequently in such foreign countries very few bills which can be purchased for remittance to the United States in payment for goods which

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[1] Publications of the National Monetary Commission, Document 569.

have been bought here. In other words, under our present banking system our imports do not create a supply of exchange on New York, for example, which can be sold in foreign countries to those who have payments to make in New York. This means that our exporters are also, to their great disadvantage, made dependent upon London. It means that when they are shipping goods to South America and to the Orient they cannot, when they are subject to competition, advantageously bill them in United States dollars. They, naturally, do not care to value their goods in local currency—that is, in the money of the country to which the goods are going—so their only alternative is to value them in francs or marks or sterling, preferably the latter, owing to the distribution and extent of British trade, creating thruout the world, as it does under the English banking system, a fairly constant supply of and demand for exchange on London. When we come to bill our goods in sterling, however, it is at once seen that our exporters are obliged to take a risk of exchange, which is a serious handicap when competing with British exporters. Our exporters who are to receive payment for their goods in sterling must previously decide on what rate of exchange will make the transaction profitable. If, in an effort to safeguard themselves against a loss in exchange, they calculate on too low a rate for the ultimate conversion of their sterling into dollars, their prices become unfavorable compared to those made by British exporters and they lose the business. If they do not calculate on a sufficiently low rate they get the business but lose money on the transaction thru a loss in exchange.

The disadvantages of which Mr. Jacobs speaks were those which prevailed at a time when gold freely circulated in the currencies of Great Britain, France and Germany. When that free circulation ceased dollar exchange proposed by him as a convenience became an absolute necessity.

Under the Federal Reserve Act, however, national banks are now permitted to accept drafts based on the importation or exportation of merchandise and the Federal Reserve banks stand prepared to discount satisfactory paper created by this class of business. Under present conditions, the Paris bank, referred to in the preceding section, would have issued a letter of credit instructing its New York correspondent to accept Brown's sixty- or ninety-day bill against delivery of the document, which bill after acceptance could be discounted by Brown's bank or its New York correspondent at one of the Federal Reserve banks. In other words the procedure would have been exactly the same as in the London case, except that the New York and not the London discount market would have carried the bill until maturity.

The Federal Reserve Act has provided machinery for such discounting and the international financial world is making constantly increasing use of the facilities offered. It is too soon to express any opinion as to the degree of permanence New York will attain as an international acceptance market. Nothing is more sensitive to restrictive conditions than international credit—it must ebb and flow freely or go elsewhere. Paternalistic in all things concerning banking and finance, the government has surrounded this concession to modern requirements with restrictions and definitions that may hamper that freedom of operation which is so essential to an international money market.

5. *Export letters of credit.*—In some countries where banking facilities are undeveloped, it was often difficult for the foreign customer to obtain a letter of credit on New York or London, or even to make a dollar remittance. In financing exports to such countries a different system was necessary in order that the American exporter could obtain his money without awaiting remittance from abroad. This system was based on the fact that in such countries banking relations with London were more intimate than those with New York. Out of this fact grew a system of "export letters of credit" which were issued by an American banker without the intervention of a foreign bank. The service which they perform in financing exports can best be understood by a concrete example. We will suppose that Williams of Chicago had sold a shipment of machinery to a firm in Honduras, where in the absence of direct exchange facilities with New York, it would have been very difficult for the Honduras merchant to purchase a draft on New York. Under these circumstances Williams, who did not wish to wait until the remittance was received, would have gone to his banker with invoices, bills of lading and other documents and would have asked him for an export letter of credit. The shipment we will suppose was worth $10,000 and against this the Chicago bank would have given Williams a letter of credit, authorizing him to draw at ninety days against its London correspondent for £1,800 or about 90 per cent of the amount of the in-

voice. This draft on London Williams would have sold in the exchange market in New York or Chicago, (letter of credit being his authorization.) In return he would have received the bulk of his money at the current rate of exchange for 90 day business. The documents would then be forwarded by the Chicago bank to his correspondent in Honduras who collects the whole amount $10,000. This sum was remitted in pounds sterling to London to the credit of the Chicago banker. Before the 90 day draft originally drawn would have matured there would have been received in London more than sufficient funds to retire it and neither the Chicago bank or its London correspondent would have had to disburse any money. The transaction would have been closed by the payment to Williams by the Chicago banker of the difference of the amount of the draft and the remittance from Honduras less any charges. As an alternative the Chicago bank would itself have drawn the draft on its London correspondent for £1,800 and have turned over to the customer the proceeds in dollars. This would have secured a better rate and the customer would have been saved the trouble of exchange transactions.

Any country, or any point, which like London before the war has direct relations with almost every part of the world, becomes the natural clearing house between countries whose exchange transactions with each other are limited.

Under present conditions it is not likely that the transactions would be carried on in this way. The American exporter would insist upon the payment in dollars. With the growth of banking relations between South American countries and the United States he could not only insist that the merchant in Honduras should establish credit in New York, but the latter would be in a much better position to do so than would have been the case a few years ago.

6. *Commercial letters of credit and importing.*—Merchants who import goods into a country can settle for them direct either by remittance or by accepting a draft drawn by the foreign merchant but such methods are now seldom followed except in the case of minor transactions. The employment of letters of credit as a medium of settlement for import goods offers greater advantages than any other method of payment both to the exporter and importer.

Altho of late public attention in the United States had been drawn rather to exports they are to a considerable and perhaps growing measure offset by imports, and the financing of such imports is a matter of great importance. Thru the use of commercial letters of credit, the importer of merchandise is able to buy goods on a cash basis in any part of the world, even tho the actual payment is deferred 60 or 90 days, which gives him a chance to dispose of the goods in the meantime. They insure for him a shipment of goods in the stipulated time, exactly as described in the credit. He is also able to order in advance goods to be manufactured according to his specifications and requirements without prepayment in advance, the letter of credit being sufficient security for the exporter. Formerly the majority of letters of credit were issued on London but the recent war and the Federal Reserve Act have brought out dollar credits issued on New York into more general use, especially for South American business.

This is a growing business and will no doubt within a very short time become thoroly familiar to the American public. For a long time, however, such transactions were handled thru London and because this represents a somewhat more familiar relation and at the same time shows the part which a world exchange center bears in the financing of exports and imports to which it is not directly a party we may follow the history of a credit established in London.

7. *British acceptances under letters of credit.*—Before the Great War shook to its foundation the financial supremacy of London its bankers granted enormous credits thruout the world which took two forms —acceptances granted under letters of credit or finance bills. The following illustration will show the operation of an acceptance under a letter of credit. When a merchant in Holland, France, the United States or any other country wished to buy goods in other parts of the globe he generally obtained the credit from a London banker directly or thru a banker in his own country. In the latter case, he instructed the foreign merchants from whom he had made his purchases to draw on the London banker at so many

months sight. Let us take the case of a tea merchant in New York, Mr. Young, who had negotiated with Napier & Company, tea growers in Ceylon, for a consignment of tea. Napier & Company probably knew little or nothing about the financial standing of Young, and even if they had known it to be excellent they would not have been willing or able to wait for a remittance from New York for the shipment. Napier therefore asked him to arrange a credit in London for the amount of the invoice say £1,000. Young went to his bankers, the Bank of New York and requested that he open up a credit in London in favor of Napier & Company against 90 day bills with documents attached. The Bank of New York then instructed Barclay's Bank, their London correspondent accordingly, and Young was furnished with a letter which he could send to Napier & Company stating that the credit had been opened in London at the terms set forth. On receipt of the letter Napier & Company filled the order and placed the tea on ship board receiving the bill of lading therefor. Napier & Company then drew a draft at 90 days sight for £1,000 and attaching the bill of lading, insurance policy, invoice, etc., thereto, took it to their banker, the Bank of Madras, Colombo, who purchased the bill from them at the current rate of the day on London. Thus Napier & Company obtained their money immediately. The Bank of Madras forwarded the draft and documents to its correspondent in London, The Bank of Commerce, who without delay presented it to Barclay's Bank, the latter accepting it, retaining the bill of lading and other documents. Later they are forwarded to the Bank of New York which was thus enabled to obtain possession of the tea when it arrived and either store it for their customer Young, on account, or deliver it to him on a trust receipt until he finally pays for it.

8. *History of the draft in London.*—To return to the draft which had now become an accepted bill with first class names on it and had an international currency. It was salable in any country of the world because every country at that time found it necessary to remit constantly to London and every foreign bank had a London office or a London correspondent. The bill could have been held until maturity and the proceeds could have been placed to the credit of the Bank of Madras, but the usual course would have been for the latter to instruct its London agent, the Bank of Commerce, to discount the bill in the open market and place the proceeds to its credit. Or, the bill may have been remitted by the agent to another foreign center to settle some accounts there. In either case, the bill whenever returned to London at its maturity was paid to the holder on that date by Barclay's Bank altho in the meantime it may have been sold several times and passed thru one-half dozen hands.

Barclay's Bank depended upon the Bank of New York to provide funds to meet the bill at maturity and would not have issued the credit unless it had had confidence in the Bank of New York. The Bank of New York in its turn had confidence in its customer's ability to reimburse it and of course it insured that the latter would provide the necessary funds for transmission to London in time to discharge the obligation.

9. *Position of the obligants on the bill.*—To sum up the results of the transaction:

1. Young, the actual debtor, had the use of £1,000 for three months and yet he, himself, would probably have some difficulty in naming his actual creditor at any particular moment.
2. Napier & Company in Colombo received their money as soon as the tea was delivered on ship board, tho as they had drawn the bill, they remain obligants until payment.
3. The Bank of Madras bought the bill from Napier & Company and was only out of its money until the bill had reached London, was accepted, discounted and placed to the bank's credit. It, however, remained until the payment of the bill liable as its indorser.
4. The Bank of Commerce advanced no money. It acted only as agent of the Bank of Madras in obtaining acceptance of the bill, selling it in the discount market and crediting the proceeds. Therefore, its name did not appear on the bill. For its services it received a commission.
5. Barclay's Bank was primarily liable on the bill as its acceptor, but as the Bank of New York had to provide the fund for payment the bank advanced no money on the transaction, it merely made a small commission for the use of its money.

The above were all interested, directly or indirectly, in the bill, but not one of them advanced a single cent. The question still remains, "Who paid for the tea during the three months currency of the bill?" The answer is: "Those firms which discounted and purchased the bill in the open discount market of London."

10. *The part London plays.*—In much the same way, merchants in every country of the world had been accustomed to arrange credits in London for every other country in the world and for every conceivable class of goods. At the outbreak of the war it was estimated by Mr. Lloyd George that British banks and acceptance houses were liable for over £350,000,000 of these acceptances, the greater part of which had been discounted on the London market. Altho British signatures were primarily liable for this huge amount, it was not really for their own account, for they looked to those on whose behalf they had accepted the bills, to provide the funds. The unprecedented demand for sterling exchange at the beginning of the war was due to the attempt on the part of foreign obligants to provide funds for the maturing liabilities incurred by the British banks for their account, and under their instructions. Exchange rates on London the world over rose far above the gold point. If Great Britain had insisted on these debts, it would have been impossible to obtain the necessary sterling funds except at a most ruinous figure. Even if the English banks could have met the acceptances as they matured out of their own funds, disgrace if not ruin would have befallen a number of the foreign banks. It was to protect this vicarious liability of the English banks that a moratorium was proclaimed and

there is no doubt that this wise step saved the neutral countries, indebted to London, both financial loss and worry. Mr. Lloyd George in referring to this class of notes says:

> There was that amount of paper out with British signatures at that time. Most of that had been discounted. The cash had been found by British sources, and the failure was not due to the fact that Great Britain had not paid her creditors abroad. It was due entirely to the fact that those abroad did not pay Great Britain. I think that it is very important from the point of view of British credit, to have that thoroly understood, for when the "moratorium" came, and there appeared something like a failure of British credit, it was not a British failure at all. It was because we could not get remittances from other countries. We had already paid, but it was vital to the credit and good name of this country that these bits of paper, which are circulated thruout the globe, with British names upon them, with names that have been associated with British trade and commerce—it was vital to the good name and credit of this country, to its continuity of trade and its character, that they should not be dishonored. What really happened was that there was a complete cessation of credit, a breakdown of the exchanges. It was exactly as if a shell had broken an arch in an aqueduct, and there was a cessation of the flow that had been going on before, and what we had to do was temporarily to repair the arch so that the flow should continue.

Before the war the acceptances under such letters of credit were not, of course, confined to London, tho London was a dominant feature in such financing. They can also be drawn, and this was done to some extent, on other large financial centers such as New York and Paris.

11. *Dollar exchange.*—The relative position of New York and London has been greatly shifted by conditions growing out of the war. American markets no longer resort to London exchange because it is easier. Not only that but in trade with places outside of North America there has been a great increase in the number of transactions financed thru such bills of exchange in New York. International conditions during the war forced upon New York the role of the world's financial center. As a result a large part of the world's trade which had heretofore been expressed in terms of sterling came to be expressed in terms of dollars. For the continuance of this condition the financial disturbance of European countries has been responsible and with the increase in facilities for such transactions which is constantly taking place and with the increased familiarity of the merchants of the world with them it is hoped that New York will retain what it has gained and make further advances. The Federal Reserve Bulletin for January, 1918, stated that the amount of outstanding acceptances representing the financing of foreign trade by London financial institutions was $500,000,000, while the amount of similar transactions in New York was $210,000,000.

The factors which make for strength in the financial world both of London and New York will receive detailed consideration in a later chapter. At this point it may be remarked that there seems to be no reason why New York should not continue to finance American trade and also share with London in general foreign exchanges if the present growth of the discount market continues. In his book on "Foreign Exchange" (1920), Mr. A. C. Whitaker says:

> *The one great factor upon which the development of New York as a foreign trade financing center depends is the maintenance there of a discount market capable of absorbing (that is buying) the great volume of bills implied in this development*, AT DISCOUNT RATES WHICH WILL AVERAGE AS LOW AS THOSE OF THE OTHER CENTER PREPARED TO OFFER SUCH A SERVICE, NAMELY LONDON. Otherwise the advantage will remain with the sterling long bill, because exporters will get more out of these bills for their shipments in the long run.

12. *Exports and imports are complementary.*—In analyzing the phenomena of international exchange as well as any other economic force it is necessary to isolate for the purpose of discussion the different factors which enter into it. It should not, however, be forgotten that in the world of business they are intimately associated with one another and that one reacts upon the other. In the explanation of international exchange the impression is frequently given that exports and imports are fixed by entirely extraneous considerations and that the other elements of exchange enter into the problem mainly for the purpose of compensating the disparity which may exist between exports and imports.

While this is true in some measure it tends to obliterate the fact that there are compensating elements as between exports and imports wholly apart from other considerations. The amounts of the exports and imports of a country depend not only upon home production and foreign needs but also are profoundly influenced by the relation of prices in different communities. If, for example, the trade current should be such that in a given year one country should receive considerable quantities of gold in payment for an excess of exports, this could not fail to have an effect upon the price levels. Prices would rise in the country receiving the gold and would fall in those which had lost it. As a result the latter on account of the high prices prevailing in the gold receiving country would be much less disposed to buy from it and consequently the latter's exports would diminish. On the other hand, the lowering of prices in the countries which had lost the gold would make them good places in which to buy. In consequence, the gold receiving country would increase its imports from those countries. Thus it will be seen that thru the medium of price changes there is always a tendency towards an equilibrium in the exports and imports themselves. The fact that gold shipments tend to bring about a dislocation of prices, which thru its influence on exports and imports drops away with the need of gold shipments, that it tends to an equilibrium in the shipment of merchandise, is set forth by Dean Johnson in his "Money and Currency" in the following statement:

> The reader will notice that the movement of gold is the direct result of the differences in the price levels of Europe

and America, which represent differences in the value of gold. He must not suppose that the disparity of prices is so great as to attract the attention of the average man. Indeed, the average man is not in a position to detect it, for prices in the United States are quoted in dollars and cents, whereas in Europe they are quoted in sovereigns, francs, marks, etc. Nevertheless the prices, whatever the names used, show exactly the purchasing power of gold in the different countries. The large importer, or the arbitrager dealing in stocks and bonds, has at his elbow tables of figures showing precisely the relation between American and European prices. When there is a slight advance in the American price of a good, without any corresponding advance in the European price, he at once knows what profit he can make by purchasing abroad and selling at home.

Variations in the rate of exchange are equivalent to changes in international price levels. A rise of sterling from $4.8465 to $4.8865 means a rise of almost 1 per cent in the cost to Americans of foreign goods, and it tends to lessen our imports just as would an actual rise in the prices of European goods. At the same time this rise of exchange from gold point to gold point is equivalent in foreign countries—or wherever sterling exchange is dealt in—to a fall of almost 1 per cent in the prices of all American goods, for the purchasing power of the sovereign in the United States rises from $4.8465 to $4.8865. Hence American exports are stimulated. A decline of exchange quotations, of course, produces opposite effects, encouraging imports into the United States and discouraging exports. When the money supply of the United States is relatively neither excessive nor deficient, the changes wrought in our foreign trade by the rise and fall of exchange quotations are usually sufficient to prevent any movement of gold. But if the money supply is excessive, so that prices of certain goods having an international market are above the price level in other countries, then our imports of goods and securities, despite the discouragement of rising exchange rates, continue in excess of our exports until an exportation of gold becomes profitable. On the other hand, if our money supply is relatively deficient, our exports will be stimulated until the large accumulation of sterling exchange forces the price down to the gold-import point.

All these forces work automatically. No man engaged in the transactions imagines that he is doing anything to correct the monetary situation of the world or to cause an importation or exportation of gold. Altho each person is seeking personal profit only, he inevitably contributes to the general result. Thus, as a result of the operations of men in different countries, each acting independently in his pursuit of profit, the rates of foreign exchange in each country are so adjusted that the value of gold in all tends to be the same, gold always moving from the country where prices are relatively high and toward the countries where prices are relatively low.

It thus appears that a country's balance of indebtedness is not determined by chance. If there were no international transactions in debts or securities, no movements of capital from country to country,—in short, no invisible trade between nations,—then the exports and imports of merchandise would balance except when an excess of gold in one country lifted the price level there and brought about an exportation of the yellow metal. The invisible elements in the foreign trade of nations complicate the subject, but introduce no new principles and lead to no new conclusion. The balance of trade, so far as visible goods are concerned, may be more or less fortuitous, depending upon the crops and upon variations in the productive capacity of a nation; but the whole foreign trade of a nation, by which is meant its imports and exports of goods and of debts, is subject to an immutable law. The exports of goods and debts always exactly equal the imports of goods and debts, except when a balance of indebtedness is created on one side or the other by differences in the value of gold in different countries.

This balance of indebtedness, it should be noted, is not the real cause of gold exports or imports, but is itself the effect of conditions which render imperative a readjustment of the gold holdings of nations.

REVIEW

Describe the commercial bill of exchange and its use.

What is meant by dollar credits? How are they used?

Describe dollar acceptances. Why were they not used in earlier days?

Explain export letters of credit.

How do letters of credit function in financing imports?

Describe the part played by the London Exchange market in financing imports before the Great War.

Why do exports and imports tend to compensate and thus check gold movements?

CHAPTER VI

INVESTMENT AND ARBITRAGE

1. *International finance.*—Intimately associated with foreign trade in affecting the rates of exchange between nations is a group of operations which can be most conveniently designated as international finance. The first step in such relations upon which subsequent developments are based is the investment of one country in the funds and securities of another. When this has been going on for a number of years there comes into being a body of securities with an international market. Speculative transactions in such securities known as arbitrage operations have similar effects on rates of exchange as do permanent investments.

A second phase of international finance which is important in this connection is the growth of banking interests with wide reaching international relations. By drawing upon each other by means of long bills designated as finance bills, these banks are able to dominate the exchange situation.

All these relations of international finance to the exchange market must receive consideration.

2. *Investments.*—It must be understood that the exchange of goods between countries involves not only goods for immediate consumption, but represents frequently the transfer of capital from one country to

another. In the case of the receiving country, imports are not immediately offset by exports of goods. Instead the sending country receives various evidences of indebtedness or ownership in the form of bonds, stocks, etc. Such a transfer of capital is characteristic of the trade of all countries and if there are any without it they must be remote and inaccessible regions like Thibet.

The effect of such capital investments upon the trade of a country may be considered. On the part of investing countries it first reveals itself in an excess of merchandise exports over imports, and in the country where the investment is made in an excess of merchandise imports over exports. On this excess of goods (capital) received, interest must be paid and eventually perhaps the capital must be reimbursed. If we assume the stream of investment to become frozen, the importing country must henceforth provide in its exports for interest and capital repayments. Hence its exports of goods must exceed its imports.

But the stream does not freeze up after a single investment transaction has taken place. It is more likely to continue for a series of years. It is naturally the younger countries with undeveloped national resources and uncultivated economic opportunities which are the fields of such investment. In them capital is relatively scarce. It commands a relatively high return and is inadequate to the task of opening up all the sources of wealth which such countries contain. This high rate of return attracts investors in older lands where capital is plentiful and obtains a low rate of reward. The prospects of profits in American and Canadian railroads, in Mexican mines, in Russian oil wells, in Brazilian coffee fields and rubber plantations, in Argentine cattle ranches, in South African gold fields and Australian sheep farms, have drawn from the careful investors of Western Europe notably in Great Britain and France, hundreds of millions, even billions, of dollars which have been invested in these and similar enterprises.

Concerning the value and benefit of such investments Sir George Paish, perhaps the foremost authority on the subject, wrote in a report to the United States Monetary Commission as follows:

> Most of the new countries are endowed by nature with almost unlimited natural wealth which can be made available for consumption by the expenditure of a relatively small amount of labor and of capital. In proportion to their natural resources the new countries possess but a small supply either of labor or of capital and they attract supplies of both from the older countries.
>
> The construction of railways across fertile prairies opens up great tracts of virgin country to cultivation at a very small expenditure both of effort and of money. The rapid expansion of agriculture which ensues gives to the new countries a large amount of agricultural produce to exchange for the goods of the other lands and to pay interest upon the capital borrowed. The introduction of large sums of capital into the new countries for railways and other purposes causes, during the period of its introduction, large imports of manufactured goods into the countries borrowing the capital and as a consequence the imports of these countries largely exceed their exports. After a time the new countries increase their production

of foodstuffs and raw materials so largely that they are able to provide a much larger proportion of the capital they need for themselves and they obtain the goods they require from other countries to an increasing extent by exchange of their own production and less by capital borrowings. I calculate that capital wisely expended upon new railways thru districts containing fair agricultural and mineral resources brings about an annual production of wealth much more than equal to the total amount of capital spent upon the construction of the railways, a rate of production which could not possibly be secured if capital were not provided for railway construction. The capital needed for the direct development of agriculture, for mining, for house building, for manufactures, and for retail trade is chiefly provided by the inhabitants of the new countries themselves. Nevertheless, a portion of the capital required for these purposes is also provided by the older countries.

3. *Foreign investments in the United States.*—During the nineteenth century the United States offered the principal foreign field for the investors of Great Britain, and a few of the Continental countries. Apart from a loan of $2,000,000 floated in London in 1836 by the Baltimore and Ohio Railroad, most of the investment of British and other European capital in the United States was, before 1850, placed in state and municipal bonds. But beginning in the fifties down to the middle of the eighties enormous amounts of foreign capital were absorbed in the development of the railway systems of the United States. More recently some of the larger industrial enterprises have drawn upon European markets for capital.

The rapid development of the wealth of the United

States in the last generation has supplied from local sources most of the capital needed for development of her enterprises. Investors in Europe in search of larger returns than the home market afforded have therefore turned their attention to other fields. For several years before the Great War there had been no very notable accretions of foreign investment in the United States, but the body of outstanding obligations inherited from earlier days was very large. The estimate for 1909, in the report before mentioned, is fuller and more complete than any other. It may be summarized as follows:

AMERICAN SECURITIES OWNED ABROAD.

	Million Dollars
Great Britain	3,500
France	500
Germany	1,000
Holland	750
Belgium, Switzerland, etc	250
	6,000

As a partial offset against this vast sum the report estimated one and a half billion dollars invested by Americans in Mexico, Cuba and South America.

4. *United States a creditor nation.*—These estimates were generally accepted at the time as substantially correct tho a few thought that the total was nearer four billion than six. Whatever the size of this investment in 1909 it is probable that the purchase of American securities on the London market

and their transfer to New York with a consequent reduction of America's indebtedness to foreign countries had begun even before the outbreak of the Great War. One of the early financial results of the war was the transfer of large quantities of these securities to American holders. In the early stages of the conflict these securities were largely used to meet Britain's demands for war materials.

Thru enormous loans made chiefly by the government and to some extent by private interests to European countries during the war, the situation became reversed. From being a debtor nation, the United States became a creditor nation. Foreign securities of all kinds are now familiar features of our stock exchanges and financial papers.

5. *International securities.*—One result of this transfer of capital is to internationalize certain securities. They are as familiar on the stock exchanges of foreign lands as on those of the land of issue. In 1909 Sir George Paish tells us, the American securities of all sorts listed on the London Stock Exchange had a nominal value of nine billion dollars, and according to his estimate given in the preceding paragraph more than one third of this amount was owned in Great Britain.

With such a wide range of securities bought and sold on the European exchanges it is evident that there as well as here they could become the object of speculative transactions as well as of "permanent" investment. We have now to examine the important effect of such speculative transactions upon the rates of exchange. Such dealings are usually known as arbitrage operations.

6. *What is arbitrage?*—Arbitrage, or as it is sometimes called, indirect exchange, is a term applied to any transaction which takes advantage of differences of prices for the same article in different markets. Arbitrage is thus defined in the Century Dictionary: "The calculation of the relative value, at the same time at two or more places of stocks, bonds or funds of any sort, including exchange, with a view to taking advantage of favorable circumstances or differences in payments or other transactions." This definition should include gold and, in a general sense, any other commodity. Wheat, for example, may be sent from one place where it is relatively cheap to another where it is relatively dear; this is arbitraging in wheat. High prices in one market induce shipments from markets with low prices and this process constantly tends to equalize prices generally.

7. *When arbitrage is transacted.*—Arbitrage transactions are confined entirely to large financial centers, such as London, New York and Paris. The work calls for expert knowledge and a close study of financial conditions, as it is essential that the arbitrageur keep in daily, if not hourly, touch with his foreign correspondents, in order that they may be prepared to carry out a transaction without delay.

A recent article in the *New York Financier* says:

In conducting such operations it is essential that the banker shall be advised, thru the cable, of the varying conditions of the markets abroad. In such markets as Paris and London, where the exchange transactions are always large, rates often fluctuate sharply and conditions change frequently. Consequently, tho the situation may be favorable one day it may suddenly become adverse, necessitating some modification of the method of arbitraging. Moreover, it frequently happens that after a successful negotiation has been effected by a banker as the result of private information, his competitors may be advised of the favorable conditions prevailing and they also may draw in a similar manner. Hence each operator seeks to obtain for himself alone all possible information regarding changes which are likely to affect his business. Sometimes a banker may find, upon calculation, that it will be profitable to conduct arbitraging of exchange between three or more points; in such cases the conditions at each of the points must first be ascertained and calculations have to be made with the utmost care. Occasionally in drawing bills the banker, in order to take advantage of arbitraging operations, will transfer credits, thru the cable, from an adverse center to a point favorable for his purpose. Indeed there are very many ways by which arbitraging can be profitably conducted by bankers having the requisite facilities and the necessary skill for such operations. It will be observed that operations in arbitraging of exchange require the services of men of the largest experience; hence the business can be conducted to advantage only in most thoroly equipped offices.

8. *Parity.*—A parity is the price at which a bill should be quoted in order to compare it with the quotations for similar bills elsewhere. To make this comparison it is of course necessary to express every quotation in a common form. Care must also be taken

to bring quotations for long bills to a demand basis, by allowing for stamps and interest.

If the New York parity on Paris had been 5.1895,[1] on the old basis of francs per dollar as against the actual rate of $5.16\frac{7}{8}$ in New York for Paris checks, an opportunity for arbitrage profit of 2.075 centimes per dollar would have been offered. On $100 this would have amounted to 40 cents, and on $48,754.56 to $195. Bankers who engage in arbitrage transactions generally construct a parity table for ready reference between the more important exchanges. The following is an example of such a table, showing parities in dollars, francs and sovereigns. Similar tables may be made for sterling, marks and dollars, for francs, marks and dollars, etc.

£1 =	25.20	25.21	25.22	25.23	25.24	25.25
	$1	$1	$1	$1	$1	$1
$4.85	5.1959	5.1979	5.20	5.2021	5.2041	5.2062
$4.85\frac{1}{4}$	5.1932	5.1953	5.1973	5.1994	5.2014	5.2035
$4.85\frac{1}{2}$	5.1905	5.1926	5.1947	5.1967	5.1988	5.2008
$4.85\frac{3}{4}$	5.1879	5.1900	5.1920	5.1910	5.1961	5.1982

[1] Attention is again called to the fact that a fixed exchange rate in one country is movable exchange in another, and both methods are used in arbitrage transactions in order to effect comparison. Paris quotes francs per dollar (i. e. fixed exchange to her but movable exchange to New York), and it is necessary to convert one or the other in order to compare.

The examples in this chapter are based upon normal conditions, those of pre-war business, and the tables and calculations are given as they were used at that time. To convert the table on this page from movable to fixed exchange at New York is a matter of simple arithmetic and is most easily done by dividing the New York quotation for £ sterling by the London quotation for francs, as $\frac{4.85}{25.20}$, leading to the result 100 francs = $19.245 + or nearest commercial rate $19.25.

If the New York quotation for sterling was $4.85 and the London quotation for francs 25.20, the New York parity quotation for francs would be 5.1959; if the market rate differed from this there would be an opportunity for arbitrage. Conversely, given the two franc quotations, the table shows the parity of the pound sterling in New York, or, given the sterling and franc rate in New York, the table shows the parity quotation of francs in London. Intermediate rates can be arrived at by interpolation. For instance, in the example given in Section 11, the sterling rate is 4.8560, the nearest quotation in the table is for 4.8550—a quarter cent making a difference of .0026 centime (5.1905—5.1879) in the quotation. Therefore, $\frac{10}{26} \times .0026 = .0010$ centime deducted from 5.1906 5.1895. The table is calculated by dividing the value of the sovereign in francs by its value in dollars, thus $\frac{25.20}{4.8560} = 5.1895$.

9. *Parity in stocks.*—Parity, when applied to a stock, means the price which is its equivalent when quoted in a different market. For instance, the London price of a stock exceeds the New York price of the same stock by about 2½ or 3 per cent, after the exchange rate and the London method of quoting American stocks ($5 to the pound) are taken into consideration. With a cable rate of 4.87½ the London parity of New York stock at 68 would be 69.75.

$$\text{N. Y. parity} = \frac{\text{London quotation} \times \text{rate of exch.}}{5} \text{ or } \frac{69.74 \times 487\tfrac{1}{2}}{5} = 68.$$

$$\text{London parity} = \frac{\text{New York quotation} \times 5}{\text{Rate of exchange}} \text{ or } \frac{68 \times 5}{487\tfrac{1}{2}} = 69.74.$$

In commodities, the prices at two different centers are at parity when the difference represents only the actual cost of transportation, insurance and interest.

10. *Chain rule.*—Most of the calculations in arbitrage transactions can be put in the form of simple equations, and require only correct reasoning for their solution. A quick tho mechanical method of calculation is called the chain rule. It consists of arranging the terms of the exchange of the various currencies under consideration, in such a manner that the required equivalent, or parity, is easily obtained. A study of the following example will make the method clear:

Berlin check rate on New York is 95 cents per 4 marks,
Berlin check rate on London is 20.5 marks per £1,
Find the parity of the sovereign in New York.

$$\begin{array}{rcl@{\qquad\qquad}rcl}
\text{How many } x & = & b & \$x & = & £1 \\
\text{if } b & = & c & £1 & = & 20.5 \text{ marks} \\
\text{and } c & = & d & \text{Mks. } 400 & = & \$95 \\
\text{and } d & = & 10\,x & & &
\end{array}$$

$$X = \frac{1 \times 20.5 \times 95}{1 \times 400} = \$4.86875$$

The last term is always in the same currency as the unknown quantity, or first term. It will be noted that these quotations are arranged in such a manner that the denominations are in sequence like the links of a chain; hence the name. The value of the unknown quantity (x) is then taken as equal to a fraction, the quantities on the right-hand side forming the numerator, and those on the left-hand side, the denominator. The product of the numerator divided by that of the denominator will give the required answer. "Chain rule" is applicable to all kinds of exchange and mercantile calculations.

How many dollars (x) = £1
If the weight of £1 = 123.274 grains standard gold
If 12 grains of standard gold = 11 grains of fine gold
And if 232.2 grains of fine gold = \$10

$$x = \frac{1 \times 123.274 \times 11 \times 10}{1 \times 12 \times 232.2} = \$4.86656$$

11. *Simple arbitrage.*—The rate of exchange between two or more places corresponds or tends to correspond. In a preceding section it was shown how the exchange rate between two places is almost automatically adjusted. Similar influences in the form of arbitrage were brought into operation to synchronize the exchange rates the world over. There was thus a certain sympathy or relation between all foreign exchange quotations. The quotations in New York for exchange on Berlin or Paris were largely influenced by the price of sterling exchange. If the price of marks in New York should fall to a point where there would be a profit in an arbitrage transaction, the demand for drafts on Berlin, by those who wish to make this profit, would almost immediately force the mark

quotation up again. Similarly New York, while a debtor to England with consequent high sterling rates, may be the creditor of France or other countries in Europe, and drafts on these countries are remitted to London and thus tend to improve (i.e., lower) the rate of sterling exchange. When only three places are involved, the transaction is called simple arbitrage.

To give a concrete case of simple arbitrage: Suppose a banker in New York had the following data before him:

London check rate in New York	$4.8560 per £
Paris check rate in New York	Fcs. 5.16⅞ per $
Paris check rate in London	Fcs. 25.20 per £

A brief calculation or a glance at his table of parities showed that there was an opportunity for a profitable arbitrage in francs between London and New York. He therefore sold a draft on Paris for Fcs. 252,000 at 5.16⅞ and with the proceeds bought a draft for £10,000 at 4.8560 per £, at the same time cabling his London correspondent to purchase a draft for Fcs. 252,000 at 25.20 per £, or better, and send it to Paris to the credit of his account there. This purchase cost £10,000 and was provided for by a draft for the same amount remitted from New York. The banker's position was then as follows:

Sale of francs 252,000 at 5.16⅞	$48,754.56
Purchase of draft for £10,000 at 4.8560 to cover purchase of Fcs. 252,000 in London at 25.20	48,560.00
Profit	$194.56

Without using any of his own capital and without any expense except the cost of a cable and a small commission to his London and Paris correspondents, the banker made a profit of over $190. The result of this and similar transactions made at the same time by other New York bankers would be to lower the New York rate for francs by increasing the supply, and to raise the London rate by absorbing the supply, thus tending to equalize rates in those international exchange centers that might have been involved.

12. *Compound arbitrage.*—The foregoing example shows the simplest form of arbitrage, but it is typical of such transactions as they are normally carried out. The banker might have found it more profitable to provide cover for his draft on Paris by remitting marks to Berlin and purchasing his francs there, or he might have instructed his London correspondent to purchase and remit a draft to Berlin with instruction to the Berlin bankers to remit francs to Paris. In the first instance he simply substitutes Berlin for London in the transaction, but in the second instance he would operate both thru London and Berlin; four places are involved, and the transaction is known as compound arbitrage.

The study of arbitrage operations is both interesting and instructive. The following transaction will bring out some of the underlying principles more clearly:

PROBLEM: It is desired to transfer $100,000 from New York to London on the basis of the data given in the first column. Which method of remittance should be selected?

It is first necessary to bring every quotation to a common form; for example, how many dollars equal £1. Care must be taken to bring quotations for long bills to a check basis, allowing for stamps, etc. The lowest parity in dollars will be the cheapest method of remitting to London, but the dearest return (remitting from London to New York), conversely the highest parity, is the dearest remittance and the cheapest return:

	Factors:	Calculation.	$ Price of £1 Check
A	Berlin check in New York,	$X = £1 check	
	Mk. 4 = 95 cents	1 = 20.5 Mk.	
	Berlin check in London,	4 = .95	
	£ = Mk. 20.5		
B	New York check in Berlin,	X = $4.8687	$4.8687
	$1 = Mk. 4.21	$X = £1 check	
	Berlin check in London,	1 = Mk. 20.5	
	£1 = Mk. 20.50	4.21 = $1	
C	New York rate on Vienna,	X = $4.8693	$4.8693
	20.30 cents per kronen......	$X = £1	
	Vienna check rate on London,	£10 = 240.17½	
	240.17½ kronen per	1 = 20.30 cents	
	£10		
D	London check in New York,	£10 = $4.8755	$4.8755
	$4.8760		$4.8760
E	Cable transfers to London in	$4.8795 less .0028	
	New York, $4.8795.........	(7 days' interest 3%)	
	London discount rate, 3%....		$4.8767
F	London 60-days draft in New	$4.85 plus .0251	
	York, $4.85................	(63 days' interest 3%)	
		and stamps .0024	$4.8775
G	New York check in Paris,	$X = £1 check	
	$1 = Fcs. 5.16¼	1 = 25.2 fcs.	
	Paris check in London,	5.1625 = $1	
	£1 = Fcs. 25.20		
		X = $4.8813	$4.8813

H	Paris check in New York, $1 = Fcs. 5.15⅝ Paris check in London, £1 = Fcs. 25.20	$X = £1 check 1 = 25.2 fc. chk. 5.15625 = $1 X = $4.8872	$4.8872

A study of the above calculation shows that the cheapest method of remittance would be thru Berlin; a pound sterling costing $4.8687. The transfer could be made either by forwarding to London a check on Berlin or by instructing the Berlin correspondent to draw on New York in favor of London. The sterling equivalent of $100,000 on this basis would be £20,539:3:0.

The dearest method of remittance is via Paris, the difference between the Paris and the Berlin rates being 1.85 cents per £, or $375 on a transfer of $100,000. The sterling equivalent of $100,000 on this basis would be £20,461:6:0. It should be noted that as the Paris method of remittance is the dearest, it is the cheapest return and would therefore be selected for the transfer of money from London to New York.

13. *Arbitrage in gold.*—Arbitrage transactions in gold and silver are of a great variety but they are all founded on the idea of sending bullion to some point where it can be used to buy exchange cheaply on some other point. The one best known of these is the so-called "triangular operation," in which gold is shipped to Paris or some other European market for the purpose of buying exchange on London. The process is as follows: The gold is shipped to Paris, and exchange on London is there purchased with the proceeds.

This exchange is remitted to London for the credit of the American bank shipping the gold; the balance so created offsetting a demand draft drawn by the latter on London. The following are the details of an actual shipment:

48.500 ounces bar gold .955 fine at $20.5684		$997,567
Freight, 1/8 per cent	$1,247	
Insurance, 4½ cents per $100	450	
Interest 6 days at 2 per cent	333	
Assay office charge, 4 cents per $100	400	
(From time gold is shipped to Paris until the drafts on London can be sold)		
Cartage and packing	60	
Com. in Paris	250	2,740
		$1,000,307
Bank of France buys gold .995 fine at fcs. 3419.81 per kilo (= 106.3705 francs per troy ounce)		
48,500 ounces at fcs. 106.3705 = fcs. 5,158,969		
Fcs. 5,158,969 at 25.10 = £205,536		
£205,536 at 4.8670 =		$1,000,342
Profit	$	35

The following are conditions under which there is practically no profit or loss:

New York Exchange on London	4.8670
Paris Exchange on London	25.10
Money in New York	2%

REVIEW

What is meant in general terms by international finance?

Describe the effect of capital investments upon balance of exports and imports of goods.

To what extent was the United States before the war indebted to European countries for capital investments?

Explain relation between investment and arbitrage operations.

What is arbitrage and what may it include?

What requirements are necessary in the work of an arbitrageur?

Define a parity. Give an example.

What is meant by parity in stocks?

Show, by examples, the difference between simple and compound arbitrage. What is the essential idea in gold arbitrage?

CHAPTER VII

FINANCE BILLS

1. *Definition of a finance bill.*—A long bill of exchange drawn by a banker or financial house in one country on a banker in another against securities in the hands of the latter is generally called a "finance bill." The privilege of drawing such bills enables bankers to anticipate a change in the rate of exchange and also to tide over a period of high exchange which otherwise would necessitate a shipment of gold. When properly used it is an important factor in international exchange and serves not only as a cheap and efficient corrective to high rates, but aids in the development of the production and trade of the world by rendering credit more fluid and leveling money rates.

There is a wide diversity in the definitions which are given of a finance bill. Franklin Escher defines it as "an unsecured long bill of exchange drawn by a banker in one country on a banker in another country and sold for the purpose of raising money." Other authorities are inclined to include all long bills originating between bankers, whether secured or not. The latter is perhaps the more general understanding of the term and the following definition is suggested as comprehensive:

A finance bill is a long bill of exchange, secured or otherwise, drawn by a banker in one country on a banker in another, the funds for the payment of which at maturity must be provided by the drawer.

When a New York banker had a satisfactory drawing arrangement with his London correspondents he was more or less independent of market conditions, and even if there was a scarcity of commercial bills on the market, he was in a position to create a supply of bills at a stated price. He was reasonably sure that he would be able to buy exchange at a lower figure to meet his obligations before their maturity, as a high rate of exchange brings out a large supply of finance bills resulting in a lowering of the rate. Mr. George Clare in his book on "Foreign Exchange" says, "The bidding need only be raised a centime or two to tap an almost inexhaustible source of supply—that of bankers' drafts." In other words, if the remitter cannot obtain a ready-made bill, he need only pay a little more and have one made to order.

2. *Finance bill for New York account.*—The most common occasion for the use of finance bills is to anticipate a fall in the exchange rates. For instance, under normal conditions, during the summer months, the rate of exchange for sterling is generally high in New York. It drops gradually until the fall, when large shipments of cotton and wheat result in heavy offerings of sterling exchange. Before drawing a finance bill, it is necessary for the New York banker to make arrangements with the accepting

bank in London as to the amount, terms, etc., of the accommodations. Such arrangements are general, applying to a series of transactions, or specific, applying to a single transaction only. Suppose the rate at the end of August some years ago was 4.88 for demand bills, and a banker, A, desirous of anticipating the probable drop in exchange in the fall, had arranged with his London correspondent, B, against securities deposited with him, for a credit of £10,000 by way of a sixty-day draft on London. A would draw a draft on B at sixty days for £10,000, which he could either (1) sell in New York at the sixty-day rate for bills or else (2) send to London to be discounted and placed to his credit there, and then sell his own sight drafts against this credit. In either case, he would have the use of the proceeds in New York until the maturity of the bill, when he must be prepared to place funds with B to meet it.

3. *Method of using finance bills.*—It will be noticed that B did not advance any money; he lent his name to A and the London discount market provided the funds. The advantages and disadvantages of this procedure may be summed up in illustrations:

1. A would sell his sixty-day bill in New York if he could obtain $4.8523 per pound sterling or better. This rate is arrived at as follows:

Demand rate for sterling		488.
[1] Less, 63 days' interest at 3% (being the London market rate for prime bankers' bills)	2.527	

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[1] Prior to the war, interest and stamps used to be calculated on the basis of $485 to the £100, but owing to the wide fluctuation they are now frequently calculated on the actual rate itself.

Stamps 1/20 of 1%	.244	2.771
Per £100		485,229

or $4.8523 per pound sterling.

The sixty-days bills for £10,000 should therefore net him	$48,522.90
A employed these funds in New York for sixty days at 4%, earning	323.49
	$48,846.39
Seven days before the bill matured A purchased a demand draft for £10,000 which he forwarded to London to provide for the payment of the bill. By this time exchange had fallen as he anticipated and was at 4.85, so that he was able to buy the covering draft for	48,500.00
A's profit (from which must be deducted B's commission of probably ⅛ of 1%) was therefore	$ 366.39

There is, of course, the risk that exchange might not fall at the end of October as anticipated, or that the interest rates in New York might not be maintained above 3 per cent.

2. If A sent the sixty-day bill to London and immediately sold a demand draft against the remittance, the transaction would work out as follows:

Amount of 60-days draft		£10,000.00
Less interest at 3%	£51.781	
Less stamps, 1/20 of 1%	5.00	56.78
Net proceeds in London		£ 9,943.22

A would thus be in a position to sell his demand draft for the above amount and provide himself with funds in New York, £9,943.22 at $4.88=$48,522.90, the same amount as realized in (1) by the sale of the sixty-days bills itself in New York.

The net proceeds, £9,943.22, are taken as the amount of the demand draft for illustrative purposes; in actual practice the draft would have been drawn in round figures, £10,000. The same result would be obtained, thus:

£10,000 demand draft realized in New York	$48,800.00
From which must be deducted the London charges for interest and stamps, £56.78 at $4.88	277.09
	$48,522.91

If, at the maturity of a finance bill, it was not convenient to collect and remit the relative loan, it was generally possible to provide the necessary funds to meet the maturing bill by the sale of another bill.

4. *Loan of a finance bill.*—The last example shows that the New York banker assumed the risk of there being a rise in the rate of exchange before the transaction had been completed and the acceptance in London retired by a sterling remittance.

So far as the actual borrower was aware, the loan is an ordinary loan in American currency; he had no means of knowing that there is any question of foreign exchange connected with the transaction. He has borrowed say $50,000 at two months at 4 per cent, but with his bank the case is different. It loaned the proceeds of a sixty-day bill on London and at its maturity would have to purchase a demand bill or cable for £10,000 at the current rate of exchange. The price paid for the bill determines the gain or loss in the transaction. If exchange rates went down as anticipated a good profit on the transaction might be made, but if the rate rose, the price to be paid might mean an even break because of the wiping out of all profit, or if the rate went high enough, an actual loss.

Bank A could eliminate this risk by loaning the bill of exchange instead of the dollar proceeds, and charging a commission instead of a fixed rate of interest; the borrower thus assuming the risk of a rise in the exchange rate. The borrower in this case, instead of receiving a loan of $50,000, would be handed A's sixty-day draft on London for £10,000. This, he would immediately sell for dollars, but when the time for repayment came, he would have to pay back not dollars but a demand draft for £10,000 which he would have to purchase at the current rate of exchange. The banker makes a commission of about one-half of one per cent for sixty days and runs no risk in the matter other than the loaning risk to his customer.

5. *A finance bill on London account.*—Another form of finance bill was created when a London banker, desirous of taking advantage of a high rate of interest in New York, instructed his correspondent to draw on him for £10,000 at sixty days and lend the proceeds on the New York market. This the New York banker did and sold the bill in New York, investing the money. Neither banker employed his own money in the operation, the money being provided by the London market where the bill was discounted. At the maturity of the loan, the London bank was placed in funds to meet its acceptance by the New York banker, or if conditions continued favorable the amount might be either renewed or reloaned in New York. A transaction of this nature

may have been entirely on the account of and at the risk of the London banker, or it may have been on joint account, in which case both the risk and the profit were shared.

6. *Other uses of finance bills.*—Finance bills, both secured and unsecured, may be drawn regardless of the conditions of interest or exchange, purely for the sake of raising money. As a rule, finance bills have a reasonable excuse for their existence. It may be objected that this is a way of getting money which might be easily abused, but in practice this does not happen. The London market is, at all times, uncannily in touch with the position of both the drawer and acceptor and any attempt on the part of either to issue this class of bill beyond what he is legitimately entitled to on the basis of his business or financial standing, is promptly nipped in the bud, first, by demanding higher rates and finally, by refusing to take the paper. Either action is, of course, detrimental to the credit of the party concerned, and bankers and others who operate in finance bills are most careful to leave a large margin for safety in their use of the very sensitive discount market. It is plain from the above explanations that when many of these finance bills are drawn on London they will have a tendency to lower the rate of exchange by increasing the supply of sterling bills on the market.

In these illustrations, London and New York have been referred to under normal conditions; finance bills, of course, obtain between other countries but to a much less degree.

7. *Forward exchange.*—Operations in "forward exchange" have several points in common with finance bills; both anticipate fluctuations in the rate of exchange and both involve a large element of risk. In its simpler and more commercial form, forward exchange or "futures," as it is sometimes called, is a term used to express the buying or selling of foreign exchange for future delivery. For instance, in July, a manufacturer in Canada accepts an order for goods to be manufactured and shipped to England before October 15. Knowing from experience that a change in the rate of exchange in October might make serious inroads into his profits, he asks his bank to quote him a rate for the amount of his shipment, and contracts to deliver the bills of exchange to the bank in October. In this way the rate is definitely fixed, and the risk of a falling rate is eliminated.

The bank can protect itself in two ways; by selling its own bills to fall due in October in London, or by selling London exchange for future delivery. As far as the obligation is concerned both cases amount to the same thing, except that in the latter no money transaction is involved. The decision of the bank is governed by the rate of interest obtaining in London in July. It is obvious that dealing in forward exchange is not necessarily based on an actual prospective transaction.

Franklin Escher, in his book, "The Elements of

Foreign Exchange," in reference to the making of money in dealing in "futures," says:

> As a means of making—or of losing—money, in the foreign exchange business, dealing in contracts for the future delivery of exchange has, perhaps, no equal. And yet trading in futures is by no means necessarily speculation. There are at least two broad classes of legitimate operation in which the buying and selling of contracts of exchange for future delivery plays a vital part.
>
> Take the case of a banker who has bought and remitted to his foreign correspondent a miscellaneous lot of foreign exchange made up to the extent of one-half, perhaps, of commercial long bills with documents deliverable only on "payment" of the draft. That means that if the whole batch of exchange amounted to £50,000, £25,000 of it might not become an available balance on the other side for a good while after it had arrived there—not until the parties on whom the "payment" bills were drawn chose to pay them off under rebate. The exchange rate, in the meantime, might do almost anything, and the remitting banker might, at the end of thirty or forty-five days, find himself with a balance abroad on which he could sell his checks only at very low rates.
>
> To protect himself in such a case the banker would, at the time he sent over the commercial exchange, sell his own demand drafts for future delivery. Suppose that he had sent over $25,000 of commercial "payment" bills. Unable to tell exactly when the proceeds would become available, the banker buying the bills would, nevertheless, presumably have had experience with bills of the same name before, and would be able to form a pretty accurate estimate as to when the drawees would be likely to "take them up" under rebate. It would be reasonably safe, for instance, for the banker to sell futures as follows: £5,000 deliverable in fifteen days, £10,000 deliverable in thirty days, £10,000 deliverable in forty-five to sixty days. Such drafts on being presented could in all probability

be taken care of out of the prepayments on the commercial bills.

By figuring with judgment, foreign exchange bankers are often able to make substantial profits on operations of this kind. An exchange broker comes in and offers a banker here a lot of good "payment" commercial bills. The banker finds that he can sell his own draft for delivery at about the time the commercial drafts are apt to be paid under rebate, at a price which means a good net profit. The operation ties up capital, it is true, but is practically without risk. Not infrequently good commercial "payment" bills can be bought at such a price and bankers' futures sold against them at such a price that there is a substantial profit to be made.

The other operation is the sale of bankers' futures, not against remittances of actual commercial exchange but against exporters' futures. Exporters of merchandise frequently quote prices to customers abroad for shipment to be made in some following month, to establish which fixed price the exporter has to fix a rate of exchange definitely with some banker. "I am going to ship so-and-so, so many tubs of lard next May," says the exporter to the banker, "the drafts against them will amount to so-and-so much. What rate will you pay me for them—delivery next May?"

The banker knows he can sell his own draft for May delivery at, say, 4.87. He bids the exporter 4.86½ for his lard bills, and gets the contract. Without any risk and without tying up a dollar of capital the banker has made one-half cent per pound sterling on the whole amount of the shipment. In May, the lard bills will come in to him, and he will pay for them at a rate of 4.86½, turning around and delivering his own draft against 4.87.

Selling futures against futures is not the easiest form of foreign exchange business to put thru, but when a house has a large number of commercial exporters among its clients there are generally to be found among them some who want to sell their exchange for future delivery. As to the buyer of the banker's "future," such a buyer might be, for instance, another banker who had sold finance bills and wanted to limit the cost of "covering" them.

The foregoing examples of dealing in futures are merely examples of how futures may figure in every-day exchange transactions. Like operations in exchange arbitrage, there is no limit to the number of kinds of business in which "futures" may figure. They are a much abused institution, but are a vital factor in modern methods of transacting foreign exchange business.

REVIEW

What is a finance bill?

Show, by an illustration, what arrangements a New York banker makes with a London bank before drawing a finance bill.

Give an example of how a finance bill on London account is created.

How does the London market prevent either a drawer or an acceptor of finance bills from issuing them beyond the amount to which they are legitimately entitled?

Describe an operation in forward exchange.

CHAPTER VIII

RATES OF INTEREST

1. *Interest an important factor in exchange quotations.*—The rate of interest at which the difference between long and short bills is calculated is based on the prevailing rate of the country on which the bill is drawn. This would not materially affect the situation if the rates of interest were uniform all over the world, but rates of interest in different financial centers vary considerably and these differences have an important bearing on exchange. Under normal conditions, international money and credit circulate most freely in the most attractive channels, and a rise in the interest rate in a foreign market will accelerate the flow of outside capital to that point, while a fall in the rate of interest will retard it. So, while demand and supply govern rates of exchange, the rates of interest at home and abroad react on these influences and affect demand and supply. Their combined effect causes the rates of exchange to fluctuate from day to day and thus the floating capital of the world is attracted from one center to another.

2. *Long bills.*—When we say that exchange rates between two countries usually fluctuate between the specie points, we refer only to the rate for demand or sight bills. This is sometimes called the pure rate of

exchange as it involves no time element except that required for the actual transmission of the draft.

Assuming that the rate at New York for a sight bill or check on London is 4.8725 how would the value of a sixty-days sight bill be ascertained? As payment in the latter case is deferred for sixty-three days (60 days + 3 days grace) it will be worth less than a demand bill by the interest for 63 days at the London rate. The calculation is based on the London rate of interest, because the holder of the bill in London can always discount it at the prevailing rate.

Assuming that the market discount rate for prime bills is 3 per cent, the rate for a sixty-days bill would be arrived at as follows:

Demand rate per £100	....	$487.25
Less 63-days interest	2.52	
Stamp 1/20	.24	2.76
		$484.49

corresponding to the nearest commercial rate, the figure would be $4,8450.

If, therefore, we know the rate of interest prevailing in foreign markets and the stamp taxes imposed by foreign countries, the rate for any long bill can readily be computed from the demand rate.

3. *Bank rate.*—In London, the bank rate is the minimum rate at which the Bank of England will discount prime three months' bills or advance money against approved securities. This rate has a direct relation to the foreign exchange rate and the move-

ment of gold. An increase in the rate would raise the value of money and attract gold from foreign centers; the lowering of the rate would tend to lower the value of money and cause its withdrawal. The Bank of England sometimes insures the effectiveness of the rate by borrowing money in the open market, thus denuding it of supplies. The Bank of England has been governed in its action in raising or lowering the rate by the relation which its reserve of gold bore to its deposits. This proportion was seldom allowed to fall below 30 per cent, while it sometimes rose above 50 per cent, the average normal condition was about 43 per cent. The importance of keeping the gold reserve intact was appreciated and it was most important to the country, as the Bank of England is primarily a bankers' bank and in a great measure controlled the gold reserve of all the British banks.

In Paris, the bank rate is that fixed by the Bank of France, in Berlin that of the Imperial Bank. In New York, the bank rate is the uniform rate of the banks as distinguished from the varying rates of the other lenders.

4. *Market rate.*—The market rate of discount, also known as the open market rate or private rate, in contradistinction to the official or bank rate, is the rate charged by bankers, bill brokers and others discounting bills of exchange. Because of competition it is usually a little lower than the bank rate, but as a rule follows the latter very closely.

Clean bills drawn upon bankers are discounted at the private rate, while those drawn upon firms in good standing are generally discounted at about ¼ per cent above the private rate.

The Bank of England rate governs the rate of interest paid on deposits by the London joint stock banks. This rate is generally 1½ per cent below the Bank of England rate.

5. *Retirement rate.*—In cases where bills have documents attached, with instructions to accept payment "under a rebate of ½ per cent above the rate of interest allowed on deposits by joint stock banks," if the bank rate were 4 per cent the deposit rate would be 2½ per cent and the rebate rate three per cent. This is known as the "retirement" rate, and the bill is said to be taken up "under rebate" in order that the drawer may obtain possession of the relative goods before maturity. Such bills are known as D/P bills (documents on payment) and are not discounted by English banks.

6. *Importance of the Bank of England rate.*—The movement of gold from one country to another, or even the probability of such a movement, is an important factor in determining the rates of exchange on the countries affected. London, owing to the extreme sensitiveness of the Bank of England rate to gold movements in normal times is particularly interested in its discount rate. Suppose, for instance, that in normal times, on account of a low sterling rate, New York commences to import gold from London. The Bank of England, seeing its stock of gold be-

coming too low, raises its official rate of discount, which is the term applied to the minimum rate at which it will discount approved bills. The London market, whose rate is usually a little lower than that of the Bank of England, will probably rise in sympathy, but if it does not do so the Bank of England, by borrowing money in the open market, will force up the rate and the effect of dear money is soon apparent. The foreign money markets, in order to take advantage of the higher interest rate in London, will allow their balances to accumulate there for investment or will purchase bills on London. British merchants will decrease their imports and increase their exports. In this way the balance of payments gradually swings around again in favor of Great Britain. Exports of gold, therefore, cause sterling rates in New York and elsewhere to stiffen and, if the high rate is maintained sufficiently long, it will check the export and eventually induce an inflow of gold to London. Thus, the reserves of the Bank of England will again become normal and the rate will then be reduced. The importance of the Bank of England ratc in controlling international exchange and gold movements cannot be overestimated, and its effects are so far reaching that monetary conditions thruout the world are directly or indirectly influenced by it. The rate is fixed by the directors of the bank on Thursday of each week and tho as few changes as possible are made, the publication of the rate is always a matter of interest to the financial world.

The Bank of England is, at all times, fully prepared to make advances against satisfactory collateral, or to rediscount approved acceptances at its minimum rate of discount. Facilities of this nature naturally create a feeling of stability and confidence among the English bankers, and the protection and assistance at their command in times of emergency enable them to conduct their business on a smaller cash reserve basis than is possible by bankers in countries without similar protection.

7. *What the Bank of England rate effects.*—It has been said that the Bank of England rate acts in normal times as a barometer of the financial condition of the world and any features of political or economic significance are reflected by its course.

Mr. A. W. Margraff[1] in pointing out the importance attaching to the fluctuation of the discount rate of the Bank of England states the various results which are effected as follows:

The discount rate:

1. Establishes the minimum rate at which the Bank of England will discount acceptable paper.
2. Fixes the rate of interest allowed by London joint-stock companies on short deposits, since this rate is one and one-half per cent under the Bank of England rate.
3. Determines the rate of interest allowed by London bankers on cash balances to the credit of foreign correspondents, keeping active accounts with them, in so much that this rate is usually ½ to 1% below the Bank rate.
4. Serves also to fix the rate of interest charged on cash

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[1] "International Exchange" by A. W. Margraff.

overdrafts, on running accounts, as debit balances are generally subject to the Bank rate, or ½ to 1% above, according to agreement.

5. Establishes the open market discount rate in Great Britain at which private bankers, London joint stock companies and discount houses will discount paper for local or foreign account, the rate ordinarily being from ¼ to ½% below the Bank rate.

6. Governs the "Retirement Rate of Discount" on documentary payment bills, which is the rate of interest rebated to the drawee, or acceptor of a documentary payment bill for the time from the date of retirement or prepayment to the date of maturity of the bill, this rate being ½% above the rate of interest allowed by London joint-stock companies for short-time deposits, which rate is based on the Bank rate as above.

7. Affects the value of all international bills of exchange as an advance in the Bank rate either advances the rate of exchange for a demand sterling draft in a foreign country or depreciates the worth of a long time sterling bill, as the interest rate for credit balances and the discount rate for long time paper are indirectly dependent upon the Bank rate.

8. Has the power of protecting the gold reserve held by the Bank of England and of checking any protracted movements of gold importations by foreign nations, in so much as an advance in the Bank rate adjusts the rates of foreign exchange to a point where operations of this nature become unprofitable.

9. Invites and attracts the deposits of foreign banks with London correspondents as an advance in the Bank rate to a figure in excess of the earning capacity at home induces continental money lenders to seek the London market for investment of their funds.

10. Indirectly has a tendency to depress or advance the values of stocks listed on the New York Stock Exchange—an advance in the Bank rate causing a decline in stock values, and a reduction in the Bank rate usually having

the opposite effect, because the values of stocks are largely dependent upon the monetary conditions obtaining in New York, and as New York bankers in periods of stringency nowadays resort to relieve the situation by issuing Finance Bills drawn upon English bankers, the Bank of England rate indirectly either facilitates or precludes their course of action.

REVIEW

What effect has the interest rate on exchange quotations?

What is the bank rate in London and what relation has it to the foreign exchange rate and the movement of gold? What is the bank rate in: France, Berlin, New York?

Discuss the market rate of discount; the retirement rate.

Show how the Bank of England rate is an important factor in determining rates of exchange.

CHAPTER IX

BILLS OF EXCHANGE

1. *Bills of exchange.*—It has already been indicated that the fundamental purpose of a draft or bill of exchange is to settle debts and thus avoid the necessity of shipping gold. To satisfy a debt in one country by offsetting the amount against a debt due in another country, leaving only the difference, if any, to be remitted in gold, is no less effective a means of payment than a double shipment of money, and is obviously more economical. In this way, the difference or balance of payments as it is called, is settled by the debtor nation shipping gold or arranging a postponement of payment by means of finance bills or other corrective transactions.

A check is merely a demand bill of exchange drawn on a bank. Bills of exchange or drafts, as we shall now call them, assume a variety of forms and tenor, but, no matter what their currency or form, the underlying principle is the same, namely, that of a creditor drawing a draft upon an actual or constructive debtor.

Bills of exchange can be broadly divided into two classes according to their currency, known as short and long exchange.

Short exchange includes cable transfers, checks, bank drafts and sight or demand drafts. Travelers' checks, money orders and other forms of non-commercial remittances come under this heading.

Long exchange includes all drafts with a currency of eight days or over, such as thirty and sixty-day commercial bills and bankers' long bills.

2. *Sight drafts.*—Checks and demand or sight drafts, whether drawn on a bank or a commercial house, have no days of grace for payment and must be paid on presentation, or protested. As a rule the sale of demand exchange is confined principally to banks, commercial drafts being usually drawn on time.

The rate or price of demand or sight exchange, under modern conditions, may be considered as the basic rate on which all rates for time exchange are calculated. The old usance or sixty-day rate, obtaining between London and New York, on which rates used to be calculated is a relic of the days of slow-going sailing vessels. In practice, of course, given the rate of interest, the rates of exchange are quickly converted from one to the other. Under normal conditions, a sight draft drawn in New York or London will be presented and paid six to eight days after negotiation in New York, and is therefore, as regards time lost in transit, on a par with a shipment of gold. The difference between the export gold point and the demand rate is represented by the freight, insurance charges, etc., on the shipment of gold. It is, of course, necessary for banks transacting a regular foreign ex-

GUARANTY TRUST COMPANY
OF NEW YORK

EXCHANGE FOR
£............................*Stg.* *New York,* ....19.....

On demand please pay..

or order (Original being unpaid) the sum of.. *Sterling*
which charge to New York account
To ....
Guaranty Trust Company of New York,
33 Lombard Street,
No............ London. ....
MANAGER

FIGURE 1. DEMAND DRAFT

change business to maintain balances with the various foreign correspondents against which they can draw demand drafts and sell cable transfers. Funds for these balances are provided by remitting quantities of different kinds of exchange which have been purchased from customers and others. Demand and other short date items are credited immediately; acceptance is obtained of the longer date items which are discounted and credited by the correspondent as occasion requires.

The selling of demand exchange and cables against remittances of the same is the most elementary form of foreign exchange. A banker, for instance, purchases a demand draft on London for £10,000 at the normal rate of exchange, say $4.86, and remits the bill to his London correspondent; at the same time he sells his own check or checks on London for the same amount at, say, $4.86½; the two transactions reach London by the same mail and offset each other. Apart from the expense of conducting his business, he clears $50 on the transaction and is not out of the use of his money for more than a few hours at the most. If the checks sold by the banker miss the mails by any chance, the banker has the use of the money in London until the mail is received; hence the importance of watching the mail service closely in exchange transactions. This illustration is, of course, elementary and bankers do not often make money this way; but it shows the principle on which foreign exchange transactions are based. Banks are constantly purchasing every kind of exchange and for-

THE CANADIAN BANK
OF COMMERCE

Sherbrooke, Que. 10th November 1916 *£956–8–7*

Sixty days after

sight of this FIRST of Exchange (Second unpaid) pay to the order of........................
The Canadian Bank of Commerce..the sum of
Nine hundred and fifty-six pounds 8/7.. *Sterling*,
Value received, and charge the same to account of
To
Davis, Jones & Co.
18 Harbour St.
Liverpool.

No. *B. E. 28*

Barclay & Dawson.

FIGURE 2. SIXTY-DAY BILL (FIRST)

THE CANADIAN BANK
OF COMMERCE

Sherbrooke, Que. 10th November 1916 *£956–8–7*

Sixty days after

sight of this SECOND of Exchange (First unpaid) pay to the order of........................
The Canadian Bank of Commerce..the sum of
Nine hundred and fifty-six pounds 8/7.. *Sterling*,
Value received, and charge the same to account of
To
Davis, Jones & Co.
18 Harbour St.
Liverpool.

No. *B. E. 28*

Barclay & Dawson.

FIGURE 2a. SIXTY-DAY BILL (SECOND)

warding it to their foreign correspondents by whom it is converted into an available balance. In any case there is constantly accumulating to the credit of the New York banker a balance against which he is able to sell exchange and cables and meet his maturing obligations. Under normal conditions, owing to the reliability of the mail service, a banker is able to estimate very closely the position of his London balance and as a rule receives a cable from his correspondent at the end of each day.

3. *Cable transfers.*—A cable transfer or "cable," as it is more generally called, is a transfer of funds by cable, no question of interest being involved as payment is immediate. Apart from this a "cable" differs from a check only in the fact that the banker abroad is told by a cable, instead of by a written order or check sent by mail, to pay out the money. The cable dispatches should be sent the night before, or early on the morning of the day on which payment is due; otherwise, owing to the difference of time between New York and London, the London bank will be closed and the payment delayed until the following day. As the money is received and paid on the same day, it is obvious that the banker must charge a higher rate of exchange for a cable than he would for a check, because he has the use of the amount of the latter while it is in transit. The mail time between the two points involved and the current interest rate at the paying point are the main factors which determine the difference in the rate of exchange between cables and

demand drafts. The higher the rate of interest and the slower the mail steamer, the more the quotations diverge. With a demand rate of exchange at $4.86, an eight-day steamer and a London market rate at 4⅞ per cent, the cable equivalent would be 4.8652, 4.86+.0052 (8 days' interest). These rates are rendered more or less divergent according to the supply of or demand for checks and cables respectively.

4. *Unusual rates for cables.*—It has already been noted that the outbreak of the European war raised cable rates on London to an unprecedented point. In his work on "International Exchange" Mr. A. W. Margraff summarizes the ordinary business conditions which produce abnormal rates as follows:

> 1. Flurries on the New York Stock Exchange with the incidental abnormal high rates for money, frequently induce New York bankers to sell their checks on London for amounts largely in excess of their cash credit balances in the hands of their London bankers, and enable them to relieve the stringency of the money market and at the same time obtain a higher rate of interest by loaning the money realized in selling their London checks.
>
> The manner of covering those checks prior to their presentation for payment in London is and can be effected only thru the purchase of cable transfers, and these operations when indulged in extensively, naturally create a brisk market demand for cable transfers, and fancy prices in many instances have to be paid.
>
> 2. Exceptionally high rates for London checks, caused by an unexpectedly heavy inquiry and a scant supply of commercial bills of exchange, might tempt the aggressive banker to avail himself of the high price by selling his checks on London short, basing his calculations on a decline in the price of exchange, during the transit of his

checks to a point where he can buy cable transfers in reimbursement for approximately the same rate he sold his checks, and in that event he would have had the free use of the proceeds of his sale of checks in the interim for loaning purposes.

Unforeseen circumstances often offset the calculations of the financier, and instead of the anticipated decline, the market has remained stationary or in fact had an advance and in the face of these conditions the many short sales of checks must still be covered by cable transfers at about any price the seller may dictate.

3. The fortnightly settlement days on the London Stock Exchange occurring about the middle and the end of each month influence also the price for cable transfers, and New York banking firms engaged in transactions in the London market frequently are called upon, especially in a wide and fluctuating market, to protect their operations by the cash payment on these days, of very large sums of money that are transferred by telegraph and result in a heavy demand for cable transfers.

4. There are many bankers not averse to having their foreign accounts show a debit balance at various times thruout the half-yearly account periods, and who thru a sentiment of pride and an implied request on the part of their European friends, always close their accounts on 30th June and 31st December with a liberal cash credit balance created in most cases at the last moment by the purchase of cable transfers.

The demand for cable transfers thru this source is sufficiently large to induce some bankers to establish large credit balances with their London friends during the months of June and December, thereby placing themselves in a position to sell cable transfers on 29th June and 30th December at the advanced prices which usually obtained then.

5. *Long exchange.*—Long-time drafts may be divided into bankers' long bills and commercial long

bills; both classes are drawn at sixty or ninety days after sight, except in special cases, when the time limit may be longer.

Commercial long bills with or without documents attached are drawn on foreign debtors by merchants and exporters against shipments of goods abroad; they are usually purchased by bankers who remit them to their foreign correspondents for collection and credit and sell their own bills against the balance so created.

When a bill of exchange is drawn for the exact value of the goods exported and has the bill of lading insurance certificates, etc., attached, it is known as a "documentary" bill of exchange. If no documents are attached to a bill, it is known as a "clean" bill of exchange. Bankers' bills are invariably clean bills, while commercial bills, unless drawn by a house of high standing on another of equal rating, are usually documentary.

Bills of exchange and the accompanying documents are usually drawn in duplicate. The originals are forwarded on the first outgoing steamer, the duplicates are sent by the next mail. Sometimes the second bill of exchange is retained until a satisfactory sale can be made, in which case the maturity of the bill is based on the date that the first of exchange was accepted in London, accurately determined by the arrival of the mail boat. The second bill of exchange bears the name and address of the holder of the accepted bill. Before payment the duplicate is attached to the original. A bill of exchange may be taken up any number of times before it is due and be put into circulation between each payment, but once it is paid by the acceptor on its becoming due it cannot again be put into circulation.

6. *Influence of the interest rate.*—A bill drawn, say, on London at sixty days after sight is obviously not worth as much to the purchaser as a demand bill. He has to pay for a sixty-day bill on delivery, send it over to London, obtain acceptance, and wait sixty-three days after acceptance before the bill matures and is paid; in other words, there is sixty-three days difference between the currencies of a demand and a sixty-day bill. Should the purchaser find it inconvenient to await the maturity of the bill, he can instruct his correspondent in London to discount it at the current rate, and have the proceeds placed to his credit. In all exchange calculations, therefore, the rate of interest is based on the current rates obtaining in the country on which the bill is drawn; this rate varies slightly according to the nature of the bill. The rates normally applicable to various classes of bills are, roughly, as follows:

Clean bills drawn on bankers' private discount rate.

Clean bills drawn on first-class firms—¼% above private discount rate.

Bills, with documents deliverable on acceptance—¾% below Bank of England minimum discount rate.

Bills drawn at over sixty days sight, bear a higher rate of discount, as a rule, than the market rate for sixties, owing to the element of risk on account of the possible change in the discount rate during the currency of the bill. It is obvious that if the London rate of discount happens to be higher than the New York rate, the purchaser of a sixty-day bill would probably prefer to allow the bill to run to maturity rather than discount it in London and use the proceeds in New York. Conversely, if the London rate was the lower he would prefer to discount the bill and withdraw the proceeds for use in New York. From the foregoing it will be seen that the London rate has a powerful influence on the exchange market. The higher the rate of discount the greater the divergence between the rate of exchange on long and short bills on London. A change in the interest rates of either London or New York is immediately reflected in the price of any bill. The conversion of a demand rate to a sixty-day rate includes an allowance for interest and British revenue stamps (1 shilling per £100). With a demand rate of 4.87 and a private discount rate in London of 3½ per cent, a banker's clean bill is worth 4.8385 as the following calculation shows:

New York demand rate on London		$487.	per £100
less 63 days' interest at 3½% . .	2.93		
Stamp duty $^{1}/_{20}$%	.24	3.17	
		$483.83	

or the nearest commercial rate, $4.8385 per pound sterling. Elsewhere it has been shown that exchange rates between two countries either correspond or tend to correspond; this applies, however, only to the demand rates.

7. *Commercial long bills.*—Commercial long bills are drafts drawn at thirty days or over by exporters on foreign customers, or upon banks abroad designated by the latter. A bill of this kind is usually accompanied by a bill of lading and other documents. Where a draft is drawn on a very good house abroad, or a bank, the documents are delivered upon the acceptance of the draft. Such drafts are known as "acceptance bills" or D/A.

Where the drawee's standing is less well-known or where the merchandise is perishable, documents are delivered only on actual payment of the drafts. These drafts are known as "payment bills" or D/P. In the case of a draft marked D/A, the drawee can obtain possession of the relative goods as soon as he, or the bank representing him, has accepted the draft. If the draft be marked D/P, the drawee must pay the draft (less a rebate for any unexpired time it has to run to maturity) before he can obtain the merchandise. When D/P bills are drawn against perishable goods they are invariably taken up "under rebate." Payment bills are not discountable, even after acceptance, as they are liable to be paid any time before maturity and must, therefore, remain in the portfolio of the banker who presented them for acceptance. "Acceptance bills," on the other hand, become clean bills after acceptance. They are discountable in the London discount market and may change half a dozen times before maturity.

The purchase of documentary bills drawn by reliable firms is a fairly safe operation, the buyer being protected by the bill of lading which is indorsed to him, but judgment should be exercised as regards the financial standing of the drawer and drawee, especially in the case of "acceptance bills," and consideration should be given to the nature of the relative goods.

8. *Bankers' long bills.*—Drafts drawn at sixty and ninety days sight, on foreign correspondents by bankers in the United States and Canada, form an important factor in international exchange operations. These bills originate in the regular course of a foreign exchange business and are based on a variety of transactions. Many of them are thirty and sixty-day bills and are sold to customers of the bank, who prefer this method of remittance to that of purchasing demand drafts or cable transfers. Some arise from a desire to anticipate a change in the rate of exchange, while others represent purely financial transactions, such as placing a foreign loan in New York. These latter operations are explained in the chapter on Finance Bills.

9. *Bills of exchange that involve more or less risk.*—Concerning the risk incurred in the purchase of documentary exchange, A. W. Margraff in his book "International Exchange" writes as follows:

Bills of exchange that may be purchased safely.—Bills accompanied by documents covering staple, non-perishable merchandise can be readily resold in the market where consigned in the event of forced sale by reason of non-acceptance or non-payment by the drawees of the appertaining bill, and the inability of drawers to reimburse the purchaser of the bill upon demand for the amount originally paid them, plus expenses.

The proceeds realized upon merchandise disposed of under forced sale would be applied on account of the amount of reimbursement demanded of drawers, and provided the merchandise was of the nature just referred to, would almost liquidate the purchaser's claim against the drawers, and the small balance still due to the purchaser may be recovered with little difficulty from the drawers. If, however, they have failed in the meantime, then the purchaser would have a creditor's claim for such balance against the insolvent drawers.

The possibility of such a loss is very remote in view of the fact that the majority of drawers of bills of exchange (exporters) have all refused bills immediately referred to their own agents abroad for protection.

Staple and non-perishable merchandise includes flour and other manufactured cereals such as corn meal, oat meal, hominy, etc.; farming implements, canned meats, fresh meats and other provisions, when the fresh meats and provisions are shipped in refrigerator cars and vessels of modern type, and warehoused in cold-storage plants upon the arrival at destination, if not immediately taken up by drawees.

Bills involving more or less risk.—Bills accompanied by documents representing shipments of perishable merchandise, such as butter, cheese, fresh fruits, etc., that are liable to deterioration in quality, or to absolute loss, during transit.

Bills with documents showing collateral security of live cattle, horses or other live animals, necessitating the expense of help and feed during transit for the maintenance of life, as a refusal of such annexed bill would depreciate the value of the security, day by day, to the extent of such expense incurred.

In addition to the liability of drawers and indorsers, if any, purchasers of documentary bills are secured by the financial responsibility of the acceptors on and after acceptance until actual payment of the bills.

The liability of drawers continues after the acceptance of bills, remains in force during the whole life of the bills and ceases only upon payment.

The primary conditions of the desirability of the purchase of any bill of exchange depend upon the moral and financial standing of the parties thereto, and the liabilities just stated of the parties should be quite ample in the majority of cases. Further, these bills possess another element of protection against a possible loss in this, that they are supplemented by documents covering salable merchandise with title continuing in the purchaser of the bills until payment at maturity, or retirement prior to maturity, of the respective bills of exchange.

APPLICATION FOR COMMERCIAL CREDIT

New York..............................

GUARANTY TRUST COMPANY OF NEW YORK.
Dear Sirs.

Please issue for our account a Documentary Credit in favor of

....
for £..........................*drafts at*..........................
against..................*cost of shipment of*..........................
from..............................*to*..............................
In force until first day of..
Insurance effected in...
Kindly advise the Credit by
CABLE
MAIL

Yours truly,

FIGURE 3.

Credit No................
£................Sterling

GUARANTY TRUST COMPANY OF NEW YORK

*New York,...........................*19..

To the Guaranty Trust Company of New York,
33 Lombard Street,
London.

Gentlemen:

At the request and for account of........................ we hereby authorize.. or any parties whose drafts you may be directed by....written order, or by us, to accept under this credit, to value on you at............for any sum or sums not exceeding in all...................................... Pounds Sterling (say £............Sterling) to be used as........may direct for.................invoice cost of.......................... to be purchased for account of...................................... and to be shipped to a..........port in the United States............

The Bills must be drawn in.................................... ....prior to the first day of......................... and advice thereof given to you in original and duplicate, such advice to be accompanied by Bill of Lading filled up to order of the Guaranty Trust Company of New York (with copy of invoice) for the property shipped as above.

All the Bills of Lading issued, except one sent to us by the vessel carrying the cargo, and one retained by the captain of the said vessel, are to be forwarded direct to you. Copy of invoice, properly certified by the U. S. Consul to be forwarded to us by the vessel, also advice of each Bill drawn.

And we hereby agree with the drawers, indorsers, and bona fide holders of Bills drawn under and in compliance with this credit, that the same shall be duly honored on presentation at your office in London.

We are, Gentlemen,
Your obedient servants,
Guaranty Trust Company of New York,
by

....
Manager.

N.B. Bills drawn under this credit must be marked Drawn
under Guaranty Trust Company of New York
Letter of Credit No..........dated....................
for £......................

Insurance in order at...............................

Figure 4.

New York,................................19...

To the

GUARANTY TRUST COMPANY OF NEW YORK

Gentlemen:

Having received from you the Letter of Credit of which a true copy is on the other side, $\genfrac{}{}{0pt}{}{I}{we}$ *hereby agree to its terms, and in consideration thereof* $\genfrac{}{}{0pt}{}{I}{we}$ *agree with you to provide in New York, twelve days previous to the Maturity of the Bills drawn in virtue thereof, sufficient funds in cash, or in Bills on London, satisfactory to you, at not exceeding sixty days' sight, and indorsed by* ^{me} *, to meet the payment of the same with ....per cent commission and interest as hereinafter provided, and* $\genfrac{}{}{0pt}{}{I}{we}$ *undertake to insure at* $\genfrac{}{}{0pt}{}{my}{our}$ *expense, for your benefit, against risk of Fire or Sea, all property purchased or shipped pursuant to said Letter of Credit, in Companies satisfactory to you.*

$\genfrac{}{}{0pt}{}{I}{we}$ *agree that the title to all property which shall be purchased or shipped under the said credit, the bills of lading thereof, the policies of insurance thereon and the whole of the proceeds thereof, shall be and remain in you until the payment of the bills referred to and of all sums that may be due or that become due on said bills or otherwise, and until the payment of any and all other indebtedness and liability now existing or now or hereafter created or incurred by* $\genfrac{}{}{0pt}{}{me}{us}$ *to you on any and all other transactions now or hereafter had with you, with authority to take possession of the same and to dispose thereof at your discretion for your reimbursement as aforesaid, at public or private sale, without demand or notice, and to charge all expenses, including commission for sale and guarantee.*

Should the market value of said merchandise in New York, either before or after its arrival, fall so that the net proceeds thereof (all expenses, freight, duties, etc., being deducted) would be insufficient to cover your advances there against with commission and interest, $\genfrac{}{}{0pt}{}{I}{we}$ *further agree to give you on demand any further security you may require, and in default thereof you shall be entitled to sell said merchandise forthwith, or to sell "to arrive," irrespective of the maturity of the acceptances under this Credit,* $\genfrac{}{}{0pt}{}{I}{we}$ *being held responsible to you for any deficit, which* $\genfrac{}{}{0pt}{}{I}{we}$ *bind and oblige* $\genfrac{}{}{0pt}{}{myself}{ourselves}$ *to pay you in cash on demand.*

It is understood that in all payments made by $\genfrac{}{}{0pt}{}{me}{us}$ *to you in the United States, the Pound Sterling shall be calculated at the current rate of exchange for Bankers Bills in New York on London, existing at the*

FIGURE 5.

time of settlement, and that interest shall be charged at the rate of five per cent per annum, or at the current Bank of England rate in London if above five per cent.

Should $\genfrac{}{}{0pt}{}{I}{we}$ *anticipate the payment of any portion of the amount payable, interest is to be allowed at a rate of one per cent under the current Bank of England rate.*

In case $\genfrac{}{}{0pt}{}{I}{we}$ *should hereafter desire to have this credit confirmed, altered or extended by cable (which will be at* $\genfrac{}{}{0pt}{}{my}{our}$ *expense and risk),* $\genfrac{}{}{0pt}{}{I}{we}$ *hereby agree to hold you harmless and free from responsibility from errors in cabling, whether on the part of yourselves or your Agents, here or elsewhere, or on the part of the cable companies.*

This obligation is to continue in force, and to be applicable to all transactions, notwithstanding any change in the composition of the firm or firms, parties to this contract or in the user of this credit, whether such change shall arise from the accession of one or more new partners, or from the death or secession of any partner or partners.

It is understood and agreed that if the documents representing the property for which the said Credit has been issued are surrendered under a trust receipt, collateral security satisfactory to the Company, such as stocks, bonds, warehouse receipts or other security, shall be given to the Company, to be held until the terms of the credit have been fully satisfied, and subject in every respect to the conditions of this agreement.

It is further understood and agreed in the event of any suspension, or failure, or assignment for the benefit of creditors on $\genfrac{}{}{0pt}{}{my}{our}$ *part, or of the nonpayment at maturity of any acceptance made by* $\genfrac{}{}{0pt}{}{me}{us}$*, or of the nonfulfilment of any obligation under said credit or under any other credit issued by the Guaranty Trust Company of New York on* $\genfrac{}{}{0pt}{}{my}{our}$ *account, or of any indebtedness or liability on* $\genfrac{}{}{0pt}{}{my}{our}$ *part to you, all obligations, acceptances, indebtedness and liabilities whatsoever shall thereupon, at your option then or thereafter exercised, without notice, mature and become due and payable.*

FIGURE 15. *(Continuation)*

10. *Letters of credit.*—There are two well-known forms of letters of credit:

1. Circular letters of credit, to be used by travelers and tourists. These are addressed to the foreign correspondent of the issuing bank in favor of the holder.

2. Commercial letters of credit, to be used in trade. These take the form of a letter addressed by a bank to a

foreign merchant, authorizing him to draw on the issuing bank's correspondent in a certain place (generally a financial center such as London or New York) for a specified amount representing the cost price of certain goods ordered by the bank's customer, on whose behalf the credit is issued. The letter designates a time-limit and specifies that all drafts shall be accompanied by the relative invoice, bill of lading, insurance policy, consular certificate, etc.

Before issuing a commercial letter of credit the bank requires the customer to sign an application form (Fig. 3 on page 141) setting forth the particulars and terms of the shipment and giving instruction in regard to terms, insurance, etc., all of which are embodied in the letter of credit, which is issued by the bank in four parts, namely, one original and three copies (these copies however vary but slightly from the original).

1. The original is addressed to the foreign merchants in whose favor the credit is issued. This is handed to the customer, who forwards it to his correspondent.
2. A copy is addressed to the London or New York bank on which the credit is issued, authorizing it to protect the drafts against the credit when drawn in accordance with the terms and conditions thereof.
3. A copy of the original is delivered to the customer for his files.
4. A copy is retained by the bank issuing the credit.

On the reverse side of the last two copies is a receipt, signed by the customer, incorporating an agreement regarding the basis on which the bank is to be reimbursed, and the amount of its commission (which varies according to the currency of the bill drawn).

The bank's rights in case of default in payment or other difficulties are also defined (Fig. 5).

Commercial letters of credit are invaluable factors, and in the promotion of international trade and commerce greatly facilitate the negotiation of bills of exchange, not only in the import business of a country but also in the export business. Letters of credit, tho not themselves negotiable, render valuable service to commerce by facilitating the drawing and negotiation of bills of exchange thruout the world.

REVIEW

What are the two classes of bills of exchange and what does each include?

How does a cable transfer differ from a check? Why are higher rates of exchange charged for it than for a check? What are the main factors which determine the difference in exchange rates between cable transfers and demand drafts?

What conditions will tend to produce abnormal cable rates?

What are: (a) commercial long bills; (b) documentary bills of exchange; (c) clean bills of exchange? Give an illustration of a clean bill and of a documentary bill.

Describe the kind of bills of exchange which are considered safe to buy and those which involve risk. What are the primary conditions which make the purchase of a bill of exchange desirable?

CHAPTER X

FOREIGN REMITTANCES

1. *Non-commercial exchange.*—Altho the greater portion of foreign exchange originates in commercial transactions, there is a constantly increasing volume of exchange business created by travelers and immigration. A steady stream of travelers and others leave the United States and Canada each year to visit Great Britain, Europe and other parts of the world, carrying with them the necessary funds for their expenses in various forms, such as circular letters of credit, travelers' checks, drafts and gold.

The remittances of immigrants to their relatives and friends in their home lands amount to a surprisingly large figure in the course of a year. These remittances are generally made by means of drafts, foreign money orders, or by what are called mail remittances.

For many years these two classes of foreign business were in the hands of foreign bankers who made a specialty of the business of supplying banks, both in the United States and Canada, with the necessary forms and foreign machinery for issuing circular letters of credit and selling travelers' checks. Gradually the larger banks both in the United States and

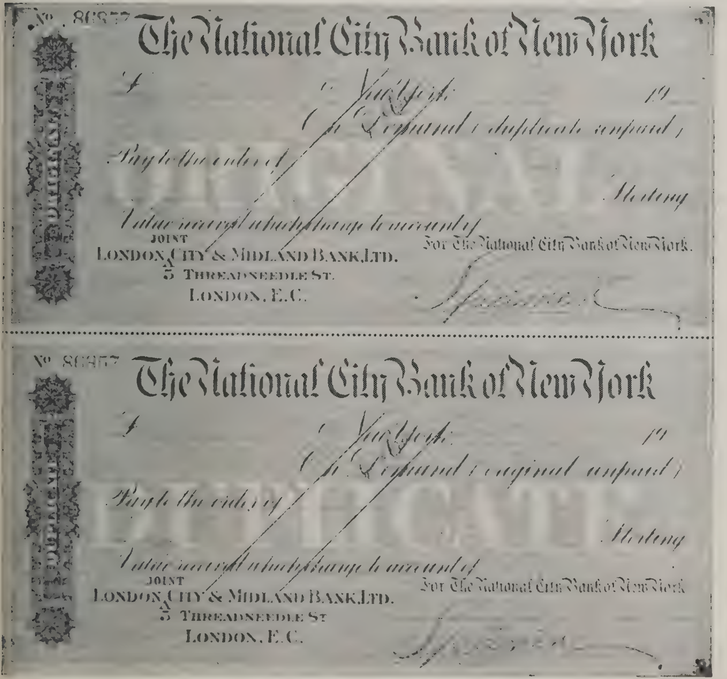
Canada felt the increasing pressure of their clients' requirements in this connection, and found it advisable to establish their own systems of travelers' checks, etc. Practically every important bank has now direct correspondents in the principal cities of the world with whom they have made the necessary arrangements for the payment of circular letters, travelers' checks and the like.

A comparison of the different methods of remittance and a description of the manner in which they are operated is interesting.

2. *Principles underlying the issuance of drafts.*—A demand draft or check is an unconditional order issued by one bank on another bank or banking firm asking the bank to whom it is addressed to pay a certain sum of money to a specified person or institution. (See Figure 6.)

In the case of a bank keeping an account in another country where the exchange value of the currency is steady and for which rate quotations are easily obtainable, drafts are usually drawn in the currency of that country and, after payment, are charged to the account which the issuing bank keeps with its correspondent at the face amount. If the arrangement calls for payment of the drafts at par, the correspondent's commission (if any) is added to the face amount of the draft when charged to the account. Drafts are often made payable at the office of a third bank or banking firm for account of the issuing bank's correspondent.

Drafts are also issued on correspondents with whom no account is kept. In such cases, cover-drafts in favor of the correspondent for the amounts involved



No. 86857 The National City Bank of New York

£ New York 19

On Demand (duplicate unpaid)

Pay to the order of

ORIGINAL

Sterling

Value received which charge to account of

JOINT
LONDON CITY & MIDLAND BANK, LTD.
5 THREADNEEDLE ST.
LONDON, E.C.

For The National City Bank of New York.

No. 86857 The National City Bank of New York

£ New York 19

On Demand (original unpaid)

Pay to the order of

DUPLICATE

Sterling

Value received which charge to account of

JOINT
LONDON CITY & MIDLAND BANK, LTD.
5 THREADNEEDLE ST.
LONDON, E.C.

For The National City Bank of New York

FIGURE 6. DRAFT

plus commission, drawn against the issuing bank's account in one of the large selling cities (London, Paris, Berlin, New York, etc.) are forwarded with the relative letters of advice, or the correspondent is requested to forward the paid draft to the issuing bank's correspondent in one of these cities for redemption.

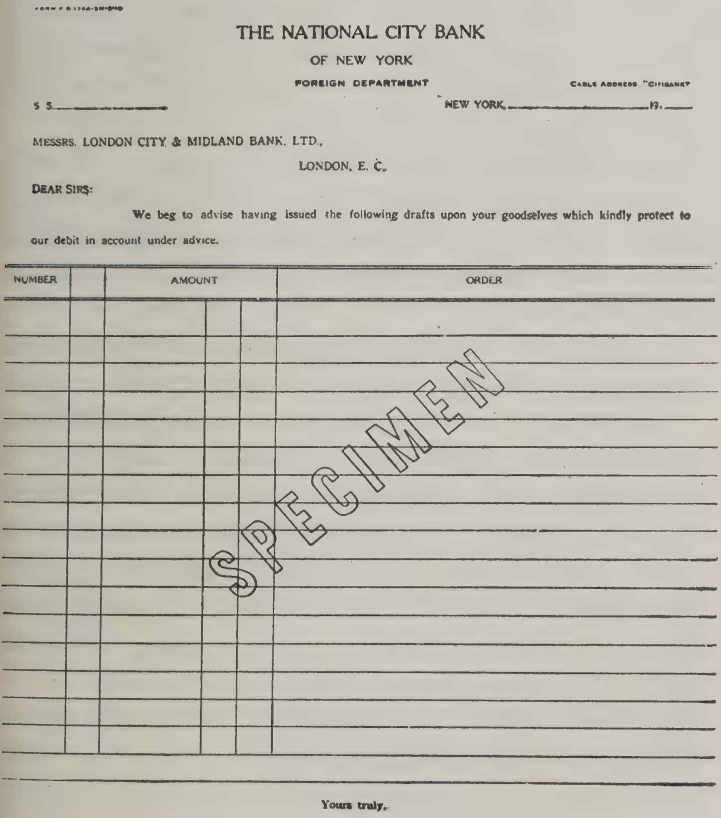
When a bank is requested to issue drafts on a country for which it has made no draft arrangements, a sterling draft on its London branch or correspondent was usually sold. Sterling drafts on London have been more easily negotiated than those drawn in other currencies, owing to the fact that the great majority of banks thruout the world have correspondents or accounts in that city, and the exchange rates for sterling were much steadier and more widely quoted than those for other currencies.

To guard against loss in the case of countries in Africa, Asia or South America where silver units exist or the exchange value of the currency is subject to great fluctuations, drafts are usually drawn in sterling on the London branch or correspondent of the issuing bank and crossed "Payable at the drawees' buying rate for sight bills on London," or with a phrase similar in meaning. The correspondent on whom such drafts are drawn pays them in local currency at a rate of exchange which includes his commission and other charges, and afterward forwards them to London for redemption at the face amount of sterling.

3. *Advices.*—A letter of advice (Figure 7), authenticating the draft and usually containing the following particulars, is sent to the branch or correspondent on whom the draft is drawn:

1. Number of the draft

2. Amount of the draft
3. Date of issue of draft
4. Name of payee
5. Name of bank at which drafts will be presented by bearer if other than correspondent drawn on (if



THE NATIONAL CITY BANK

OF NEW YORK

FOREIGN DEPARTMENT

CABLE ADDRESS "CITIBANK"

$ S.______ NEW YORK,______19.___

MESSRS. LONDON CITY & MIDLAND BANK, LTD.,

LONDON, E. C.

DEAR SIRS:

We beg to advise having issued the following drafts upon your goodselves which kindly protect to our debit in account under advice.

NUMBER		AMOUNT			ORDER

Yours truly,

FIGURE 7. LETTER OF ADVICE (DRAFTS)

the draft is to be readvised to bank at which it will be presented, a note to this effect is added to the advice).

6. Particulars of the mode of reimbursement (cover-draft inclosed, debit amount to account, etc.).

Should the draft be payable by a third party (see above) for account of the correspondent on whom it is drawn, this third party is also advised either by the issuing bank direct or by its correspondent on receipt of advice from the issuing bank.

The relative advices should be dispatched as soon as possible after the sale of the drafts in order that payment may not be refused thru the correspondent's being unable (in the absence of advice) to authenticate the drafts.

4. *Specimen forms and signatures.*—Each bank furnishes the correspondents on whom it has arranged to issue drafts, with specimens of the special draft form and of the special advice form (if any) it will use, together with specimen signatures of the officers who are authorized to sign drafts and advices on its behalf. If possible, a specimen signature of the payee is also forwarded with the advice of a draft, so that any possible difficulty in establishing the *bona fides* of the payee and draft may be avoided.

5. *Cost of drafts to purchasers.*—The amount to be charged by the issuing bank to the purchaser of a demand draft is ascertained by adding together the amounts mentioned below:

1. Face amount of the draft (if drawn in a for-

eign currency the amount is converted into local currency at the rate of exchange for the day)

2. Commission of the issuing bank
3. Commission (if any) of the paying bank
4. Cost of postage on advices.

6. *Travelers' checks.*—Travelers' checks enable a traveler to provide himself with funds without delay in a convenient yet inexpensive manner, at any point of his journey. They are issued in denominations of even amounts ($10, $20, $50, $100 and $200; £5, £10; 200 francs and 400 francs. Equivalents in foreign money are now no longer stated upon such checks. (See Figures 8 and 9.) They may be cashed practically anywhere, are self-identifying and easily negotiated, and are therefore one of the safest and best forms in which to carry money when traveling. They are issued by all first-class banks at a small premium.

So far as travelers are concerned, such checks are often more convenient than drafts. The latter must be cashed in one lump sum which may be much larger than the traveler wishes to carry on his person, and which may be a positive disadvantage if he passes into another country where a different currency is in use. The checks are for relatively small amounts, can be cashed as needed and are generally accepted by hotels and large stores, without imposing on the traveler the burden of cashing them at a bank.

In view of the undoubted advantages in their particular sphere which travelers' checks possess over drafts, their greater cost, the widespread nature of the initial arrangements and the fact that the exchange charged by correspondents on the checks is met by the issuing bank, the slightly higher commission charge which is made by banks for travelers' checks is fully justified.

7. *Payment of checks.*—The issuing bank usually holds the paying agents of their travelers' checks free from responsibility in cashing such checks, provided:

(a) The holder signs them in the presence of the paying agent.

(b) The signature of the holder and that of the countersigning officer agree with the signatures contained in the relative letter of indication.

(c) The numbers of the checks are entered on the letter of indication.

(d) The checks are negotiated within the period specified (usually twelve months from date of issue).

(e) The other general terms of the circular of instructions are duly complied with.[1]

8. *Payment to holders.*—In countries other than France or Great Britain travelers' checks are now paid in local currency at the day's rate for the country in whose currency they are drawn. When revenue stamps are required their price is deducted.

When a fixed amount of sterling is specified for Great Britain on the face of travelers' checks, it should

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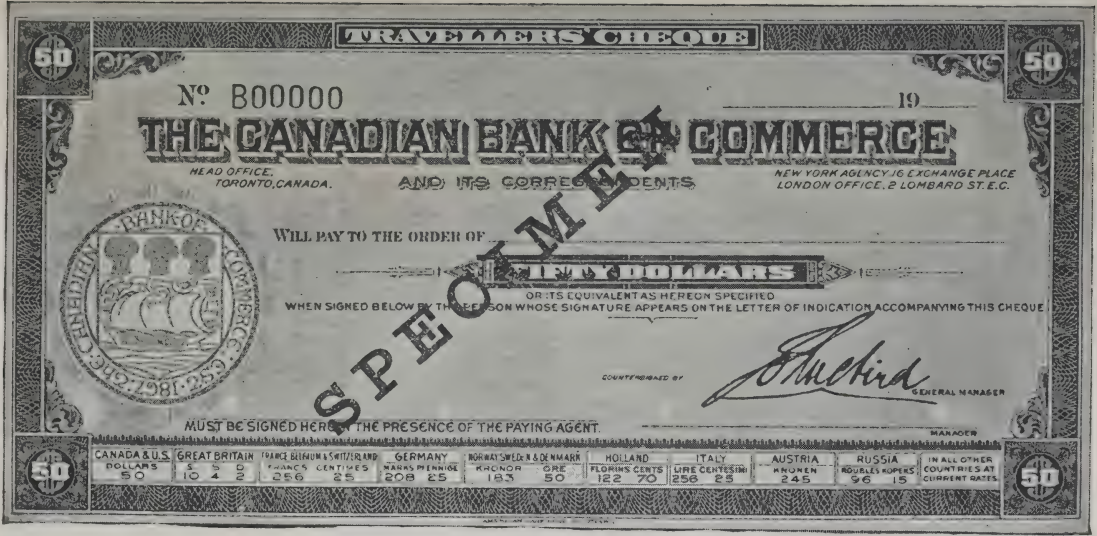
[1] This circular of instructions is generally printed in the principal commercial languages for the benefit of paying agents.



TRAVELLERS' CHEQUE

50

Nº B00000 ______ 19___

THE CANADIAN BANK OF COMMERCE

HEAD OFFICE.
TORONTO, CANADA.

AND ITS CORRESPONDENTS

NEW YORK AGENCY 16 EXCHANGE PLACE
LONDON OFFICE, 2 LOMBARD ST. E.C.

WILL PAY TO THE ORDER OF ______

FIFTY DOLLARS

OR ITS EQUIVALENT AS HEREON SPECIFIED

WHEN SIGNED BELOW BY THE PERSON WHOSE SIGNATURE APPEARS ON THE LETTER OF INDICATION ACCOMPANYING THIS CHEQUE

COUNTERSIGNED BY ______

GENERAL MANAGER

MUST BE SIGNED HERE IN THE PRESENCE OF THE PAYING AGENT. ______

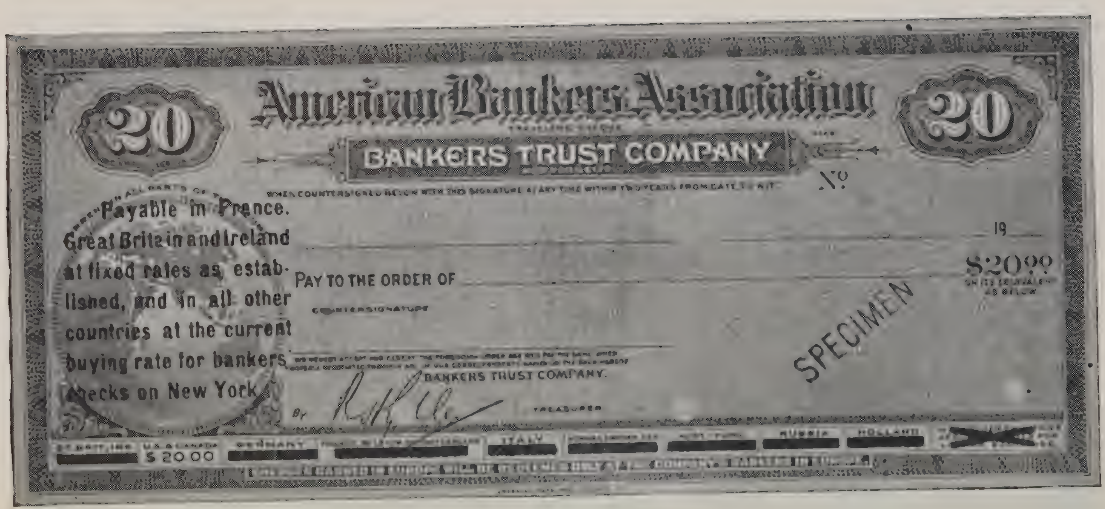
MANAGER

SPECIMEN

CANADA & U.S.	GREAT BRITAIN	FRANCE BELGIUM & SWITZERLAND	GERMANY	NORWAY SWEDEN & DENMARK	HOLLAND	ITALY	AUSTRIA	RUSSIA	IN ALL OTHER COUNTRIES AT CURRENT RATES
DOLLARS	S. S. D.	FRANCS CENTIMES	MARKS PFENNIGE	KRONOR ORE	FLORINS CENTS	LIRE CENTESIMI	KRONEN	ROUBLES KOPEKS	
50	10 4 2	256 25	208 25	183 50	122 70	256 25	245	96 15	

FIGURE 8. TRAVELERS' CHECK

During the war the equivalents designated as payable in enemy countries, or countries occupied by the enemy, were canceled.



20

American Bankers Association

BANKERS TRUST COMPANY

20

No

Payable in France. Great Britain and Ireland at fixed rates as established, and in all other countries at the current buying rate for bankers checks on New York.

19

PAY TO THE ORDER OF

$20⁰⁰

SPECIMEN

BANKERS TRUST COMPANY.

By

TREASURER

$20.00

FIGURE 9 TRAVELERS' CHECK

"Owing to the unsettled political conditions and the consequent irregularity of exchange rates, it is not feasible to show rates on checks which may be printed some time before actual sale to travelers. Fixed rates are established from time to time with French and English correspondents and these rates may be obtained by the traveler at the time of purchase by inquiry at the issuing bank, who are advised of such changes."

be borne in mind that the sterling current in Australia, British South Africa, British West Indies, etc., is of a quite different exchange value. A similar remark may also be made regarding the colonies and dependencies of other countries which use the same currency (francs, etc.) as the respective mother country. In such places all travelers' checks are paid at the current rate for purchasing exchange on the capital of the respective mother country.

9. *Redemption of checks.*—Paid travelers' checks are redeemed as follows:

(a) If paid in North America, they are forwarded to the New York office or correspondent of the issuing bank of redemption at the face amount of dollars plus the commission agreed upon.[1]

(b) If paid outside North America, they are forwarded to the London, England, branch or correspondent of the issuing bank for redemption at the current rate of exchange plus commission at the rate agreed upon or when issued in dollars are returned to New York either directly or indirectly to be redeemed to the credit of the foreign banker who cashed them. A number of purely temporary expedients have been resorted to in view of the unsettled condition of sterling. It is believed these will in time give place to the former more convenient methods.

---

[1] As travelers' checks paid in North America are checks on New York, banks at points where New York exchange is usually at a premium often make no commission charge for cashing the checks.

In the case of Canadian banks which issue travelers' checks, it is customary to redeem each other's checks at par when the two banks concerned are represented locally. In other cases they are redeemed thru the Clearing House or otherwise by any branch of the issuing bank which is convenient for the purpose, at the face amount plus the usual commission on checks paid and redeemed in North America, namely, $1/10$ of 1 per cent, minimum 5 cents each.

(c) Banks having extensive business relations with various European countries occasionally appoint their chief correspondents in the respective countries as central redemption agents for their travelers' checks. In such cases the paid checks are forwarded to these correspondents for redemption at the face amount of local currency plus the commission agreed upon, and are debited to the account which the issuing banks keep with these correspondents.

(d) Hotels, department stores and private bankers often hand travelers' checks paid by them to a local bank for redemption, such third parties being allowed a commission of, say, 1/20 of 1 per cent, which is added by the local bank to its own commission when forwarding the check to a central correspondent for redemption.

10. *Letter of indication.*—Each purchaser of travelers' checks is furnished with a letter of indication (Figure 10), usually bound with the list of paying agents, specifying the numbers of the travelers' checks sold to him and signed by the purchaser and the officer who countersigned the checks. It is indispensable to the security of the holder that this letter of indication be carried separately from the travelers' checks, as in case of loss of one or the other the one remaining serves as the basis of a claim for reimbursement.

A few institutions do not issue a letter of indication with their travelers' checks. In these cases two spaces, one at the top and one at the bottom (see Figure 11), are provided on the check form for the signature of the holder. The first signature is made in the presence of the officer who issues the checks, and the second in the presence of the paying agent, who compares the two signatures to establish their identity. This system, however, readily lends itself to forgery should the checks be lost or stolen, as the presenter of the checks has a copy of the necessary signature before him while signing the checks, or the signature may be lightly traced in pencil in the space provided before presentation and covered with ink in the presence of the paying agent.

During 1913 the *Fédération Universalle des Sociétés d'Hôteliers* (with which the principal hotels of the world are associated) addressed a circular letter to the various issuers of travelers' checks stating that in view of the risk involved, payment by the leading hotels of travelers' checks of this form would thereafter be more or less uncertain, and suggesting that the banks adopt the safer method whereby the specimen signatures of the purchaser and the countersigning officer are given in a separate letter of indication.

11. *Lost travelers' checks.*—The same care should be taken of travelers' checks as of money, and due precautions taken to avoid risk of loss. Should this occur, however, the holder is advised to communicate immediately by telegraph with one of the redemption agencies of the issuing bank or the branch at which

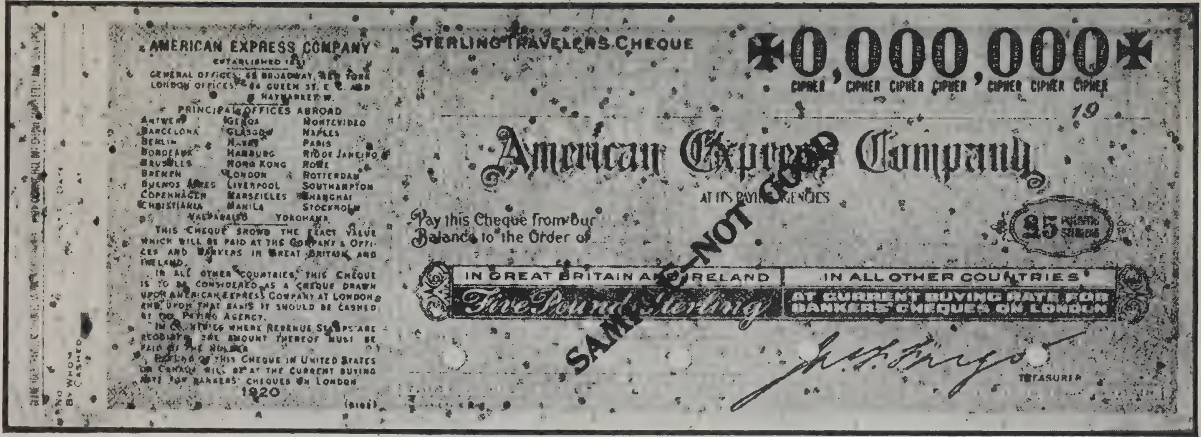
the checks were obtained, so that the presenter of such checks may be traced without delay.

The issuing bank will usually refund to the owner the face value of lost or destroyed checks, or will issue a new supply in their stead, upon receipt of sufficient evidence of loss or destruction thereof and the execution of a satisfactory bond of indemnity, provided the holder immediately notifies the bank by telegraph of the loss as mentioned above.

Travelers' checks are useful for those carrying comparatively small sums of money, as they can be negotiated at hotels, department stores, etc., where it is impossible to secure funds under letters of credit, but those who require to provide themselves with large sums, say, $1,000 or over, will find a letter of credit more convenient. A good plan for many travelers is to carry both.

12. *Letters of credit.*—The principal banks of the world issue letters of credit designed specially for the use of travelers. They are accompanied by a letter of indication (Figure 12), and are of two kinds, namely: (a) Domestic, drawn in local currency for use in the country where they are issued as, for example, dollars in America and francs in France, (Figures 13 and 13A), and, (b) Foreign, now usually drawn in dollars and similar in form to Figure 13 tho letters in sterling and francs are available (Figures 14 and 14A).

The holder of one of these credits may draw any sum he desires, up to the amount of the credit, thru correspondents at all the principal places visited by



No.
By whom cashed
Date

AMERICAN EXPRESS COMPANY
ESTABLISHED [illegible]
GENERAL OFFICES: 65 BROADWAY, NEW YORK
LONDON OFFICES: 84 QUEEN ST. E. C. AND
6 HAYMARKET W.

PRINCIPAL OFFICES ABROAD

ANTWERP	GENOA	MONTEVIDEO
BARCELONA	GLASGOW	NAPLES
BERLIN	HAVRE	PARIS
BORDEAUX	HAMBURG	RIO DE JANEIRO
BRUSSELS	HONG KONG	ROME
BREMEN	LONDON	ROTTERDAM
BUENOS AIRES	LIVERPOOL	SOUTHAMPTON
COPENHAGEN	MARSEILLES	SHANGHAI
CHRISTIANIA	MANILA	STOCKHOLM
	VALPARAISO	YOKOHAMA

THIS CHEQUE SHOWS THE EXACT VALUE WHICH WILL BE PAID AT THE COMPANY'S OFFICES AND BANKERS IN GREAT BRITAIN AND IRELAND.

IN ALL OTHER COUNTRIES, THIS CHEQUE IS TO BE CONSIDERED AS A CHEQUE DRAWN UPON AMERICAN EXPRESS COMPANY AT LONDON AND UPON THAT BASIS IT SHOULD BE CASHED BY THE PAYING AGENCY.

IN COUNTRIES WHERE REVENUE STAMPS ARE REQUIRED THE AMOUNT THEREOF MUST BE PAID BY THE HOLDER.

REFUND OF THIS CHEQUE IN UNITED STATES OR CANADA WILL BE AT THE CURRENT BUYING RATE FOR BANKERS' CHEQUES ON LONDON

1920

STERLING TRAVELERS CHEQUE

0,000,000
CIPHER CIPHER CIPHER CIPHER CIPHER CIPHER CIPHER

19

American Express Company
AT ITS PAYING AGENCIES

Pay this Cheque from our Balance to the Order of

£5 POUNDS STERLING

IN GREAT BRITAIN AND IRELAND	IN ALL OTHER COUNTRIES
Five Pounds Sterling	AT CURRENT BUYING RATE FOR BANKERS' CHEQUES ON LONDON

SAMPLE—NOT GOOD

TREASURER

Figure 11 Travelers' Check (in sterling) Without Letter of Indication

.................................19.....

TO OUR CORRESPONDENTS:
Gentlemen,

M ....
whose signature is to be found below, is the holder of our Travelers' Checks as follows:

No. X........................to No. X...................inclusive,
of the denomination of $10.
No. A........................to No. A...................inclusive,
of the denomination of $20.
No. B........................to No. B...................inclusive,
of the denomination of $50.
No. C........................to No. C...................inclusive,
of the denomination of $100.
No. D........................to No. D...................inclusive,
of the denomination of $200.

We commend .... to your usual courtesies.

FOR THE..........................BANK

....
(This signature must agree with the countersignature on the checks.)

SIGNATURE OF

....
(Must be inserted at the time the checks are purchased.)

LETTER OF INDICATION ACCOMPANYING TRAVELERS' CHECKS

FIGURE 10

.............................19.....

TO OUR CORRESPONDENTS:
Gentlemen,

M ....
the bearer of this letter, whose signature is to be found below, has been supplied with our Circular Letter of Credit No......and we commend...... to your usual courtesies.

FOR THE.......................BANK

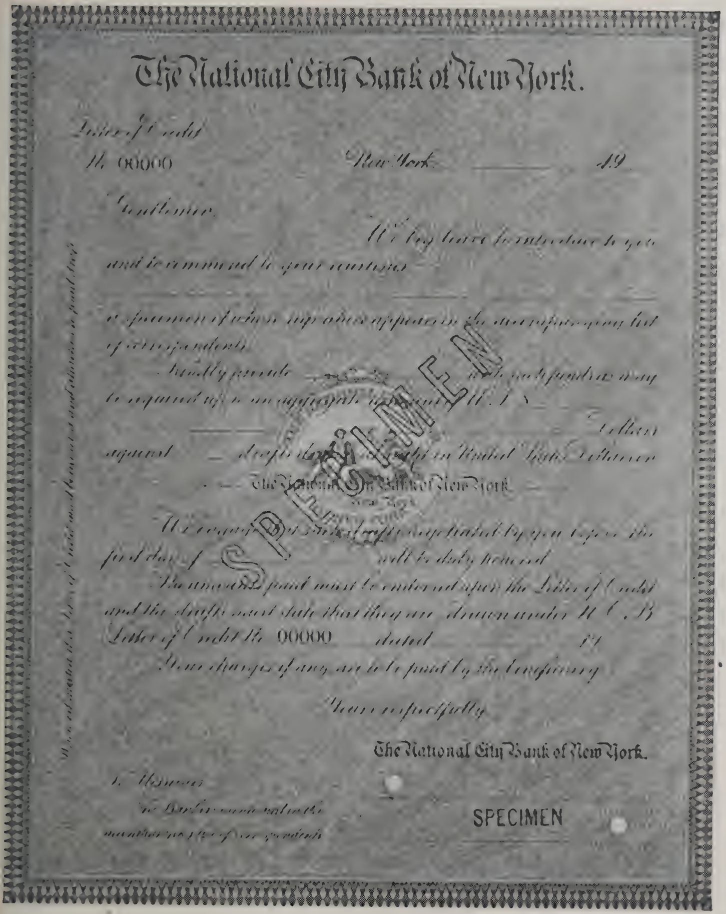
....

SIGNATURE OF

....

LETTER OF INDICATION ACCOMPANYING LETTER OF CREDIT

FIGURE 12



The National City Bank of New York.

Letter of Credit
No. 00000 New York ________ 19

Gentlemen,

We beg leave to introduce to you and to commend to your courtesy ________ a specimen of whose signature appears in the accompanying list of correspondents.

Kindly provide [illegible] with such funds as may be required up to an aggregate amount of U. S. ________ Dollars against ___ drafts at sight in United States Dollars on The National City Bank of New York.

We engage that such drafts negotiated by you before the first day of ________ will be duly honored.

The amounts paid must be endorsed upon the Letter of Credit and the drafts must state that they are drawn under N. C. B. Letter of Credit No. 00000 dated ________ 19

Your charges if any are to be paid by the beneficiary.

Yours respectfully,

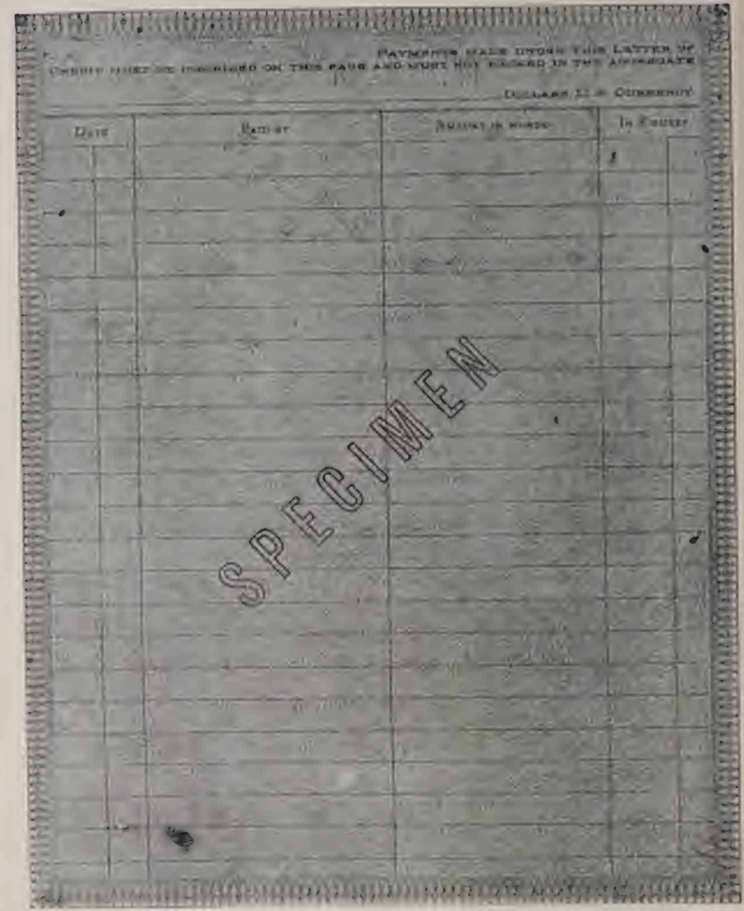
The National City Bank of New York.

To Messrs.
The Bankers [illegible]
mentioned in list of correspondents

SPECIMEN

[illegible]

FIGURE 13. CIRCULAR (DOLLAR) LETTER OF CREDIT (FRONT)



PAYMENTS MADE UNDER THIS LETTER OF CREDIT MUST BE INSCRIBED ON THIS PAGE AND MUST NOT EXCEED IN THE AGGREGATE

DOLLARS U.S. CURRENCY

DATE	PAID BY	AMOUNT IN WORDS	IN FIGURES
			$

SPECIMEN

Figure 13a. Circular (Dollar) Letter of Credit (Back)

CIRCULAR LETTER OF CREDIT

No. . . . .

£. . . . . *Stg.*

ISSUED BY

THE. . . . . .BANK.

. . . . 19. . . .

To the Bankers
named in our Letter of Indication.

This letter will be presented to you by
. . . .
. . . . *in whose favor we have opened a credit of*
. . . . *Sterling*
to be availed of by . . . . *demand drafts on*
The. . . . . .Bank, London.
which we request that you will negotiate at the current rate of the day, less your usual charges.

The drafts should bear the following clause:—"Drawn under Credit No. . . . ."; they should be drawn within one year from the date hereof, and the date and amount of each draft cashed are to be entered in the space provided on the back of this letter.

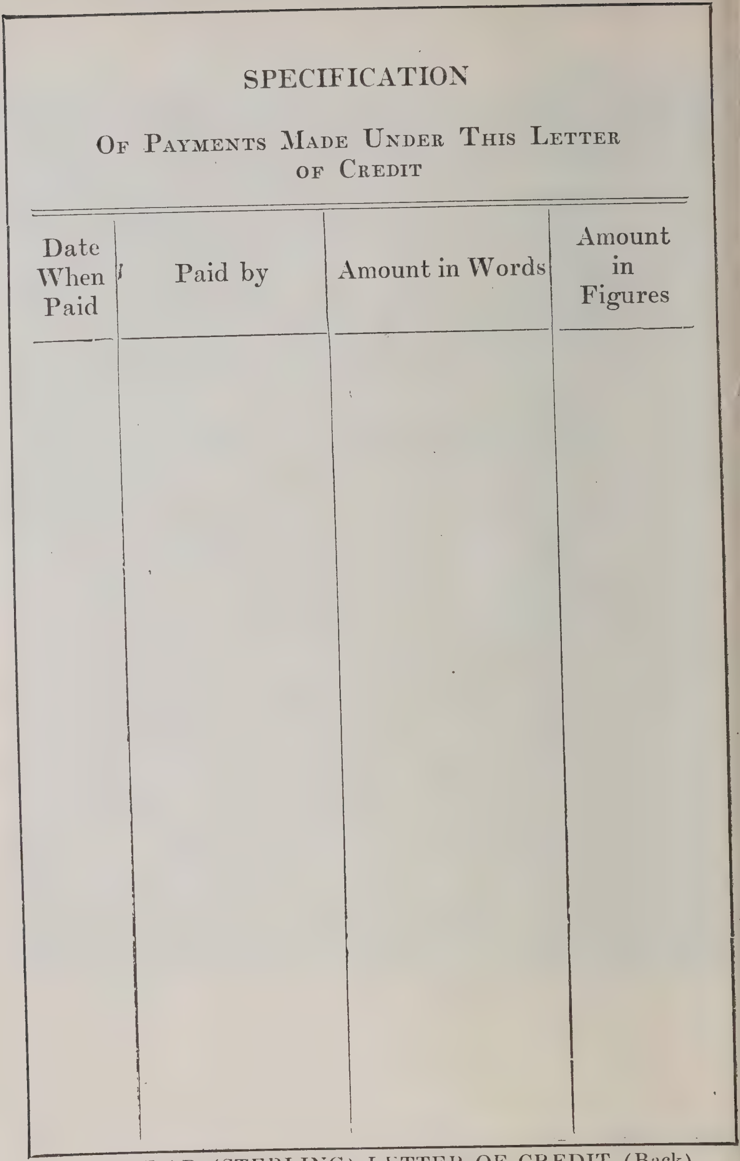
M. . . . .
provided with a copy of our Letter of Indication, whereon . . . . *signature may be found.*

For The. . . . . .Bank.

. . . .

. . . .

CIRCULAR (STERLING) LETTER OF CREDIT
FIGURE 14



SPECIFICATION

OF PAYMENTS MADE UNDER THIS LETTER OF CREDIT

Date When Paid	Paid by	Amount in Words	Amount in Figures

CIRCULAR (STERLING) LETTER OF CREDIT (Back)

FIGURE 14a

business men and tourists thruout the world. A list of paying agents is supplied to each purchaser.

13. *Payment to the holder.*—The holder draws a draft on the central correspondent of the issuing bank designated in the letter of credit for the amount of money he requires and presents it to one of the paying agents designated in the list of paying agents. The paying agent then compares the signature on the draft with that given in the relative letter of indication and authenticates the signature of the officers appearing on the letter of credit by means of the specimens he has on file. If the signatures are in order he makes payment and enters the particulars of the draft on the back of the letter of credit.

In accordance with the usual banking custom the paying agent deducts his commission at the time payment is made to the holder of the letter of credit, but should the letter of credit request him to make payments without deduction, his commission is added to the amount of the draft when forwarding it for redemption to the branch or correspondent of the issuing bank named in the letter of credit. If the letter of credit is not drawn in local currency, the paying agent makes payment at a rate of exchange which includes his commission.

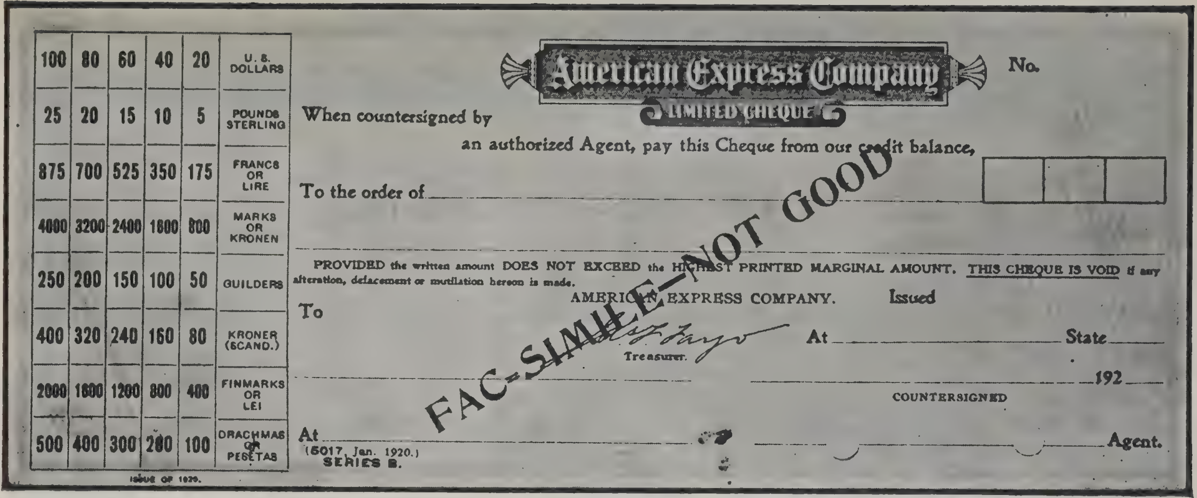
The banker who pays the draft, exhausting the letter of credit, forwards it to the central agent together with the draft for redemption.

Advised or restricted letters of credit are similar in form to circular letters of credit, except that they are advised direct to the correspondents to whom they will be presented for payment, and specimen signatures of the holder are forwarded to these correspondents, so that a letter of indication is unnecessary.

Letters of credit are available for the period specified thereon only (generally twelve months or less), and paying agents should always take care to see that this period has not expired when a letter of credit is presented to them for negotiation.

14. *Circular notes.*—Circular notes (often written in French) are similar in form, payment and redemption to travelers' checks. They are issued for fixed even amounts of a given currency (pounds sterling, dollars, etc.), and are payable at that amount without deduction in countries which use that currency. In countries where the local currency differs from that designated on the circular notes, the equivalent of the amount is paid at the current rate of exchange. Altho formerly very popular, circular notes have largely fallen into disuse. Only two British banks were issuing them in November, 1920, and the important tourist companies had practically discontinued selling them.

15. *Foreign money orders.*—There is no cheaper, safer or more convenient means of remitting small sums of money to any part of the world than that of foreign money orders or bankers' limited checks (Figure 16). The latter have fixed limits in various currencies, the rates of exchange being determined at the time the notes are purchased in America.



100	80	60	40	20	U. S. DOLLARS
25	20	15	10	5	POUNDS STERLING
875	700	525	350	175	FRANCS OR LIRE
4000	3200	2400	1600	800	MARKS OR KRONEN
250	200	150	100	50	GUILDERS
400	320	240	160	80	KRONER (SCAND.)
2000	1600	1200	800	400	FINMARKS OR LEI
500	400	300	200	100	DRACHMAS OR PESETAS

ISSUE OF 1920.

American Express Company

LIMITED CHEQUE

No.

When countersigned by

an authorized Agent, pay this Cheque from our credit balance,

To the order of

PROVIDED the written amount DOES NOT EXCEED the HIGHEST PRINTED MARGINAL AMOUNT. THIS CHEQUE IS VOID if any alteration, defacement or mutilation hereon is made.

AMERICAN EXPRESS COMPANY.

Fargo

Treasurer.

Issued

To

At State

192

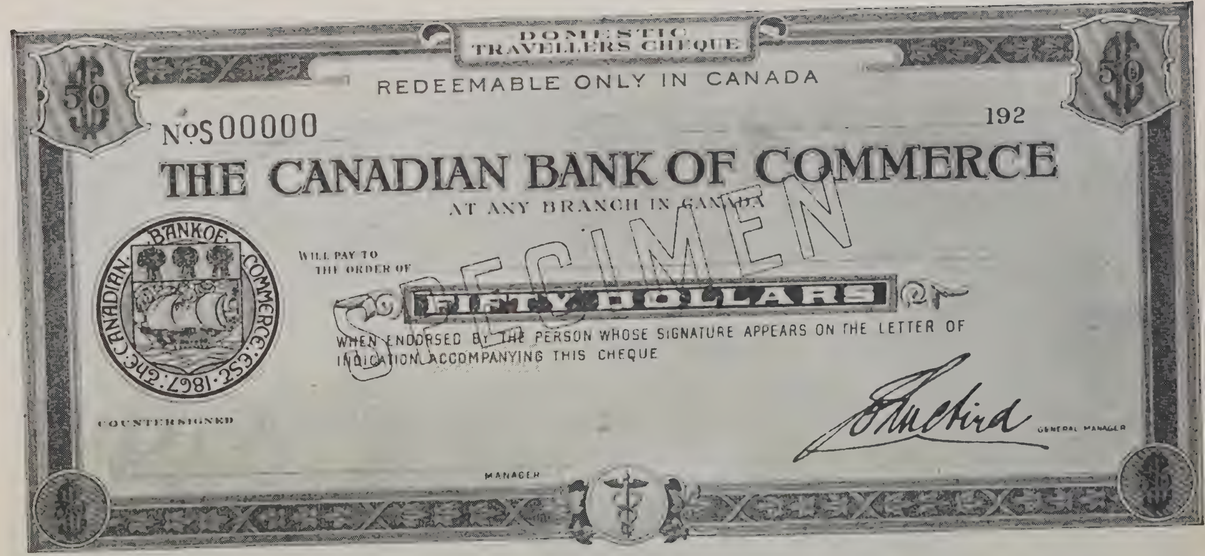
COUNTERSIGNED

At Agent.

(5017 Jan. 1920.)
SERIES B.

FAC-SIMILE—NOT GOOD

Figure 15. Foreign Limited Check



DOMESTIC
TRAVELLERS CHEQUE

REDEEMABLE ONLY IN CANADA

No S 00000 — 192

THE CANADIAN BANK OF COMMERCE

AT ANY BRANCH IN CANADA

WILL PAY TO
THE ORDER OF

FIFTY DOLLARS

WHEN ENDORSED BY THE PERSON WHOSE SIGNATURE APPEARS ON THE LETTER OF INDICATION ACCOMPANYING THIS CHEQUE

COUNTERSIGNED

MANAGER

GENERAL MANAGER

SPECIMEN
50
50

Figure 16. Canadian Domestic Traveler's Check

This form is representative of traveler's checks issued by all the Canadian banks. Altho they are domestic within Canada, they partake of the nature of foreign remittances when purchased from Canadian branch banks in the United States for use by American travelers in Canada. For such use they have achieved very considerable popularity.

16. *Payment of orders.*—Foreign money orders are *not* usually advised to the paying agents, but the issuing bank, as a rule, holds the paying agents of their foreign money orders free from responsibility in cashing them, provided:

(a) The money orders are drawn on the proper form.

(b) The amount of any one money order does not exceed the limit fixed by the issuing bank.

(c) The signatures of the officers on the money order agree with the specimen signatures of authorized signing officers on file.

(d) The money order is presented for payment within, say, twelve months of the date of issue. (After the expiration of this period the money orders are payable only at the head office of the issuing bank.)

PAYMENT TO HOLDERS

(a) In Great Britain and Ireland the face amount of sterling is paid to the holder without deduction except for revenue stamps if the order is drawn in sterling. Dollar orders and checks are paid at the rate of exchange for New York funds on the day they are presented.

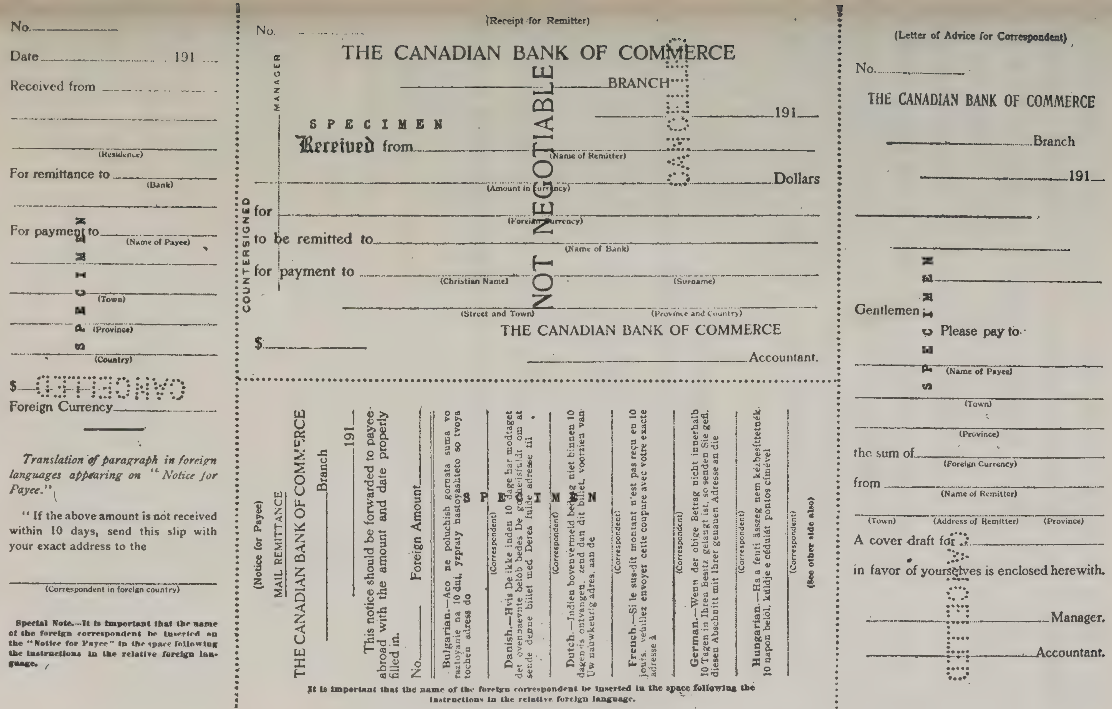
(b) In countries other than Great Britain and Ireland the equivalent of the dollar amount is paid to the holder at a rate of exchange which includes the commission and other charges of the paying agent. In countries where a revenue stamp is necessary the cost of such stamp is charged to the holder of the foreign money order.

REDEMPTION

(a) Foreign money orders paid in Great Britain and Ireland are redeemed by the London, England, branch or correspondent of the issuing bank, at the face amount of sterling plus the commission agreed upon if drawn in sterling, or at the dollar equivalent at the rate of exchange on the day of payment.

(b) Foreign money orders paid in countries other than Great Britain and Ireland are redeemed by the London, England, branch or correspondent of the issuing bank at the dollar equivalent at the rate of exchange on the day of payment.

17. *Mail remittances.*—To meet the requirements of emigrants and to facilitate the transfer of sums of money to places where banking facilities are somewhat limited, a special class of transactions, called mail remittances, has been instituted. By this system a bank in one country requests its chief correspondent in another country to pay a certain sum to a specified person in that country, and incloses a draft in favor of the correspondent to cover the amount involved and the correspondent's commission (which is usually the same as for drafts). The correspondent in the country then forwards the amount (or its equivalent in local currency) to the beneficiary by registered mail or thru its agents in the town where the beneficiary resides.



No.

Date 191

Received from

(Residence)

For remittance to

(Bank)

For payment to

(Name of Payee)

(Town)

(Province)

(Country)

SPECIMEN

$

Foreign Currency

Translation of paragraph in foreign languages appearing on "Notice for Payee."

"If the above amount is not received within 10 days, send this slip with your exact address to the

(Correspondent in foreign country)

Special Note.—It is important that the name of the foreign correspondent be inserted on the "Notice for Payee" in the space following the instructions in the relative foreign language.

(Receipt for Remitter)

No.

THE CANADIAN BANK OF COMMERCE

BRANCH

191

MANAGER

SPECIMEN

NOT NEGOTIABLE

Received from

(Name of Remitter)

Dollars

(Amount in Currency)

for

(Foreign Currency)

to be remitted to

(Name of Bank)

for payment to

(Christian Name) (Surname)

(Street and Town) (Province and Country)

COUNTERSIGNED

THE CANADIAN BANK OF COMMERCE

$

Accountant.

(Notice for Payee)

MAIL REMITTANCE

THE CANADIAN BANK OF COMMERCE

Branch

191

This notice should be forwarded to payee abroad with the amount and date properly filled in.

No. Foreign Amount

SPECIMEN

Bulgarian.—Aco ne poluchish gornata suma vo raztoyanie na 10 dni, yzpraty nastoyashteto so tvoya tochen adress do

(Correspondent)

Danish.—Hvis De ikke inden 10 dage har modtaget det ovennaevnte beløb bedes De godhedsfuldt om at sende denne billet med Deres fulde adresse til

(Correspondent)

Dutch.—Indien bovenvermeld bedrag niet binnen 10 dagen is ontvangen, zend dan dit biljet, voorzien van Uw nauwkeurig adres, aan de

(Correspondent)

French.—Si le sus-dit montant n'est pas reçu en 10 jours, veuillez envoyer cette coupure avec votre exacte adresse à

(Correspondent)

German.—Wenn der obige Betrag nicht innerhalb 10 Tagen in Ihren Besitz gelangt ist, so senden Sie gefl. diesen Abschnitt mit Ihrer genauen Adresse an die

(Correspondent)

Hungarian.—Ha a fenti összeg nem kézbesittetnék 10 napon belöl, küldje e cédulát pontos címével

(Correspondent)

(See other side also)

It is important that the name of the foreign correspondent be inserted in the space following the instructions in the relative foreign language.

(Letter of Advice for Correspondent)

No.

THE CANADIAN BANK OF COMMERCE

Branch

191

SPECIMEN

Gentlemen:

Please pay to

(Name of Payee)

(Town)

(Province)

the sum of

(Foreign Currency)

from

(Name of Remitter)

(Town) (Address of Remitter) (Province)

A cover draft for

in favor of yourselves is enclosed herewith.

Manager.

Accountant.

FIGURE 17. RECEIPT FOR MAIL REMITTANCE

In order to make sure that the amount reaches its destination safely, the purchaser is furnished by his bank with two slips, one a receipt for the money he has paid and the other a notice (with translations thereof in various foreign languages) for transmission to the beneficiary, which instructs him (the beneficiary) to communicate with the central correspondent if the sum mentioned thereon is not received within the course of a fixed number of days. (See Figure 17.)

REVIEW

What is a demand draft? Describe some of the ways in which drafts are paid.

What does a letter of advice usually contain?

How are travelers' checks redeemed?

What is a letter of indication? Why is it issued?

What kinds of letters of credit are issued? How does the holder secure payment?

When are paying agents of travelers' checks free from responsibility in cashing such checks?

CHAPTER XI

THE SILVER STANDARD

1. *Silver standard.*—A country is upon the silver standard when its legal tender monetary unit consists of a definite quantity of silver, free coinage being permitted. In such a country the money value of silver coins is practically the same as the commercial value of the bullion which they contain. In such countries of course, silver and money are regarded as identical, just as gold and money in gold standard countries are thought of as being practically one and the same thing.

Only one country of commercial importance is now upon the silver standard, namely, China. The subject of silver exchange, therefore, is not of great importance to the business world; as a middle term, however, between the gold standard and the paper standard, it has far greater significance in the exposition of the principles underlying exchange operations. In the nineteenth century there was a long and bitter conflict between the advocates of silver and gold, some important nations being on the silver basis, others on the gold basis, and still others on a joint or bimetallic basis, the free coinage of both silver and gold being permitted and the coins of both metals being legal tender. The adherents of the gold standard triumphed over their silver opponents in the latter half of the nineteenth century, and in the last thirty years all the important nations of the earth have sought to put their monetary systems upon the gold basis.

Altho the silver standard exists in only one great country, nevertheless it is well for the business man to understand the fundamental principles governing silver exchange and the international movements of silver as a commodity, for all gold standard countries make large use of silver in their subsidiary coinage.

2. *Silver mint par.*—When several countries of the earth were on the silver basis, exchange relations between them were determined exactly as are exchange relations between two countries on the gold basis. In the early part of the nineteenth century the United States, altho nominally on a bimetallic basis, was really upon a silver basis, for gold coins were not in circulation, being worth more as bullion than as money. At the same time many important nations of the world, such as Germany, Russia and India, were on the silver basis. In those days the mint par between the American silver dollar and the German thaler was merely a question of mathematics, being determined by the quantity of silver in the one as compared with the quantity of silver in the other. That of course is the method, as has already been explained by which the mint par between the moneys of countries which are upon the gold basis is determined.

3. *No mint par between countries on different standards.*—When two countries use different metals as money, each being freely coined, it is obvious that there can be no stable value relation between their coins, and therefore no mint par unless the commercial values of the two metals move up and down in absolute unison. Of course, under ordinary conditions the values of two commodities never move up and down together at all times. Hence quotations of exchange between countries on different standards cannot be comparable to a mint par.

It is worth while recalling, however, that in the old days of bimetallism prior to 1870, when many countries were on the joint standard of gold and silver, the variations in the value fluctuations of the two metals were so slight that for the purposes of international trade something like a bimetallic mint par did exist. This is a matter which has been the subject of much debate in the last fifty years, but it possesses no practical importance at the present time and therefore deserves no further discussion.

4. *Exchanges between gold and silver countries.*—International trade between countries on different bases is hampered by uncertainties that do not exist in the case of trade between countries on the same standard, for in the former case a certain speculative element or risk is always present. When an exporter in a country on the gold basis ships goods to a country on the silver basis, the price being quoted in terms of silver, he cannot be certain that silver will not fall in

value with respect to gold before he receives his pay. He was inclined, therefore, to demand from his customer a higher price than he would ask if he were selling to a customer in a country on a gold basis. Or else the merchant in the gold country insisted upon trading on the gold basis and put the entire burden of fluctuating exchange on the buyer. In either case this risk operated to the detriment of business men in silver standard countries, and such countries have during the last fifty years quite generally endeavored to place themselves upon the gold basis.

5. *Gold price of silver.*—We have seen that the exports of a country are stimulated whenever its monetary unit is quoted below parity in foreign exchanges, and that the opposite effect upon trade is exerted when rates of exchange rise. For example, the French franc was quoted at about eight cents in March, 1921. It is obvious that American imports from France would tend to decline if its gold value should rise to nine cents, unless at the same time a corresponding drop in prices took place in France.

The exchange quotations between gold and silver standard countries are practically a reflex of changes in the relative values of the two metals. If the gold price of silver is rising, quotations of Chinese exchange will advance in London, and vice versa. Changes in the relative values of the two metals have in the past produced important changes in the currents of trade. For example, during the seventies and eighties of the last century the gold price of silver steadily declined.

India was then upon a silver basis and her general level of prices did not undergo great changes. As the price of silver fell, it was possible for English importers of wheat to import that commodity from India at constantly lessening expenditures of gold. During this period the farmers of the United States inspired by the advocates of the free coinage of silver, complained bitterly because the price of a bushel of wheat was being steadily forced down by competition with a country which had the advantage of being on the silver basis.

6. *Real situation as to silver.*—Speaking of the arguments in favor of the use of silver which were drawn from the experience of India, Dean Joseph French Johnson in his "Money and Currency" says:

> To business men, as well as to farmers and producers generally, the silver advocate addressed an argument based upon the apparent prosperity of India. India had become our chief competitor in the wheat markets of the world. Until 1893, her money had been silver, and the friend of silver held that the wheat growers of India, on account of the falling price of silver, had been able to undersell the farmers of the United States at Liverpool year after year, without themselves making any change whatever in the price of their wheat. The Indian exporter of wheat, who sold it at from three to four rupees[1] per bushel in 1873, had averaged the same price during the full twenty years, and with the money he had received he had each year been able to buy about the same quantity

---

[1] The rupee contains 165 grains of pure silver and in 1873 was equivalent to 44 cents. After 1873 its gold value declined, until in 1893 it was worth only 26 cents in gold.

of goods or pay the same amount of debt, for general prices did not rise in India prior to 1893. But four rupees of silver after 1873 represented a lessening amount of gold, so that an American farmer, in order to compete with the Indian producer, had been obliged to lower his price year after year. Thus, when the price of silver had fallen until a rupee of 165 grains of pure silver was worth only 30 cents in gold, the American farmer in order to compete with Indian wheat at three rupees was obliged to sell his wheat at 90 cents. The advocates of the free coinage of silver, using illustrations of this sort, argued that the adoption of the silver standard would give us a tremendous advantage over foreign nations using gold as money. The free coinage of silver would not only have the effect of a protective tariff, lessening our imports of foreign goods but would also stimulate our exports by giving our producers an advantage like that which the producers of India had enjoyed.

As for the argument based on India's apparent command of the wheat markets of the world after 1873, that also contained several grains of truth. If two competing countries are using different monetary standards, say silver and gold, a change in the value relation between the two metals will give a temporary stimulus to the exports of that nation whose money metal is falling in value with respect to the other. This stimulus is due to the maladjustment of prices that always accompanies a change in the value of a money metal. Whenever the value of silver falls in Europe or the United States because of an increasing supply or diminished demand, the decline is indicated by a fall of the gold price of silver before the general price level in silver-standard countries has been much affected. Before 1893, for example, a decline in the price of silver in Europe could not affect prices in India until additional silver had been added to India's money supply and put into circulation among the people. Consequently, when the gold price of silver fell because of a fall in the value of that metal the producers of India were under no inducement on that account to charge higher prices for their goods, for their money costs of production had not increased. An ounce of silver meant as much to them as it had meant before the decline of the London or New York quotation for silver; but since it now took less gold to buy an ounce of silver, it was possible for Europeans to buy a given quantity of India's products with less gold than formerly. In consequence American and European producers who were competing with Indian producers were obliged to lower their prices, altho the only cause therefor seemed to be a change in the relation between gold and silver.

Such a condition would of course be temporary unless the fall in the value of silver were continuous. India would increase her exports until a balance had been created requiring an importation of silver sufficient to raise her price level to parity with the value of silver in Europe and the United States. Thus when the value of silver was falling India's exports of goods were always a little larger than they otherwise would have been, the excess representing the value which India gave to the world in payment for the additional silver required in her circulation.

When the gold price of silver fell because of a rise in the value of gold, as most commonly happened between 1873 and 1893, the effect upon India's export trade was more apparent than real or permanent, and was due to the maladjustment of prices in gold-using countries. When the gold price of silver changes, exporters and importers are usually unaware of the cause and do not seek to discover it; it is commonly assumed in gold-using countries that the value of silver has fallen, and in silver countries that the value of gold has risen. So whenever the gold price of silver fell after 1873, whatever the cause, the first effect was always the same, namely, importers in gold countries were able to get goods from India by the expenditure of less gold than before the fall, and consequently American and European producers in competition with India were obliged to lower their prices. But when the change was due to a rise in the value of gold, the value of silver not declining, there was no reason why India should import an unusual amount of silver, for India did not then need any addition to her money supply. Nevertheless the exporters of India had a temporary advantage in the world's markets. Without any sacrifice they were able to cut under the gold price which had prevailed for the same goods. But their advantage could be only temporary, for prices in the gold countries, since gold was increasing in value, soon fell to a level which placed the European and the American exporter on a par with the Indian exporter. Any long delay in the adjustment of prices in gold countries would continue India's advantage and give her an unusual balance of trade, but the resultant importation of silver would lift her price level and so deprive her exporters of their advantage over exporters in gold countries. In fact such an importation of silver, after prices in gold countries had become adjusted to the new value of gold, would put Indian exporters at a disadvantage for a time and perhaps cause an exportation of silver.

7. *Silver and international exchange.*—Altho serious consideration of the adoption of a bimetallic standard has practically disappeared during the last twenty years, silver continues to exert a powerful influence in international exchange. The flurry in the price of silver that followed the war has only served to re-emphasize the importance of the metal. There is only one commercially important country left in which silver is the standard of value—the only legal tender—namely China, but the close relation of the metal to money and exchange is maintained by its world wide use as subsidiary coinage. Moreover all the Far Eastern countries maintain a consuming de-

mand for silver. Nor is the expression "consuming demand" a mere figure of speech in this case. Reference is constantly being made to the "voracious appetite" of China for the precious metal and India is characterized as a "bottomless pit." The silver demand of these countries is due to the use of vast quantities for hoarding, for ornaments (especially in India), and for currency purposes. The latter use has for many years been the principal factor in the demand, but more recently hoarding is believed to have gone on to a vastly increased extent. It remains an undisputed fact that silver that once goes into China or India seldom comes out again. Conservative estimates place the amount absorbed by India between 1914 and 1920 at 500,000,000 ounces and China during the same time bought fully 400,000,000 ounces of bar silver.

War conditions brought about an increased demand for subsidiary coinage thruout the world. War industries were extended to the silver using countries of the East. The soldiers of all the warring nations used large quantities of subsidiary coin and all troops in East Africa and Mesopotamia had to be paid in silver. The allied nations were buying the products of the Far East in immense quantities and, as every nation was conserving its gold supply, they soon became heavy buyers in the silver market. Industrial use, in which the manufacture of moving pictures is the chief factor, continued to require about 70,000,000 fine ounces a year. All these conditions brought about, between 1914 and 1920, price fluctuations of silver that were unprecedented.

8. *Asia's historic influence.*—One of the reasons which no doubt has contributed to the scanty attention paid to the subject of Eastern exchange is the fact that few people have realized until recently the very important influence that the East has exercised from the beginning of history, and will undoubtedly continue to exercise, on the economic life of the West, or so-called civilized world. Asia has always exerted a passive influence on human enterprise, due in a great measure to her insatiable appetite for the precious metals. Three thousand years before the Christian Era the Phoenicans ranged far afield to Spain and distant Britain in search of gold and silver with which to maintain their trade with the Orient for silk, spices and other luxuries. Later the Venetians gained control of the caravan routes to the East, and further depleted the European supply of the precious metals. This immensely lucrative trade of Venice aroused the envy of Portugal and Spain, and inspired voyages of discovery and the search for a sea route to the East which resulted in the discovery of America by Columbus, and Vasco da Gama's successful voyage around the Cape of Good Hope. The discoveries came at an opportune time. The gold and silver mines of Europe were practically exhausted and there was no other source of supply. The trade with the Orient thru Venice was a steady drain on a constantly diminishing stock, and the shortage of precious metals

as a medium of exchange had long acted as a deterrent on the industrial and economic progress of Europe. The flow of gold and silver to Spain from America gave Europe the long wanted impetus, which enabled her to throw off the fetters of the Middle Ages and brought about a revival of learning and industry in every branch of human activity.

9. *How silver is marketed.*—A second outstanding reason for the general lack of knowledge regarding Eastern exchange is the result of the way in which silver has been marketed. The operations have been in the hands of a few highly trained experts.

London for several centuries has been the chief market for silver, owing in a great measure to her long and intimate connection with the Eastern trade, first established by the old East India Company, and since maintained and increased by direct marine service and other well established interests. The course of Eastern exchange rests almost entirely on the price of silver, the market for which, for several generations, has been principally in the hands of four London firms, as follows: Mocatta & Goldsmid, Samuel Montague & Company, Pixley & Abell and Sharp & Wilkins. The first mentioned firm dates back to 1684, ten years before the Bank of England was founded. Before the war these four firms determined the price of silver at a certain hour each day—1.45 P. M. (Saturday 11.45 A. M.) and the bulk of the world's transactions in silver was based on this price, which in turn established the rate of Eastern exchange, the actual operation of which lies principally in the hands of the great Anglo-Asiatic banks, The Hongkong & Shanghai Banking Corporation, The Chartered Bank of India, Australia & China, and The Mercantile Bank of India, Limited. Exchange operations under these conditions required a highly specialized knowledge, not only of the silver market, but also of Eastern conditions themselves, and were practically confined to highly trained employees of the banks and brokers above-mentioned. Intensive information therefore was only available to those actually engaged in the operations. These men were evidently too busy, or not of a sufficiently literary turn of mind or inclination, to place their experience or knowledge on record.

A change in the market methods seemed to be foreshadowed in 1917. In September of that year the United States controlled silver and did not permit its export except under license. In April, 1918, the Pittman Act came into force, and for a time was regarded as a most important piece of legislation. This act authorized the sale of silver not exceeding 350,000,000 silver dollars from the silver reserve of the United States. Out of this, the equivalent of 270,000,000 fine ounces, the share of India was 200,000,000 fine ounces, which was bought by the British Government and imported into India in the following year. The act further stipulates that silver sold under its provision shall be replaced by purchases made at the fixed price of $1.00 per fine ounce, and that the metal so purchased must be "the product of mines situated in the United States and of reduction works so located." As is usually the case with legislation that tries to combat economic laws, other than its action in placing a possible bonus on silver mined in the United States, the only result of its provisions has been to establish two separate and distinct markets and quotations. In the United States, domestic commercial silver is virtually pegged at 99½ cents. Foreign silver is also quoted on the New York market, but moves with the London price, which has returned to its position as arbiter of the silver exchange rates.

10. *The silver price flurry.*—The statistics of the world's annual production of silver show that an astonishing decrease has taken place since 1913. Nearly 234,000,000 fine ounces were produced in that year. In 1914 only about 160,600,000 ounces were mined, and altho production has increased beyond that amount in later years, the 1920 figures show it to be still far below normal. Simultaneously with this decrease in production came the great increase in demand, the reasons for which were outlined in an earlier section.

Erratic is the mildest word that can be applied to the market between 1915 and the end of 1920. In midsummer of 1915 the monthly average price of silver fell to 48½ cents per fine ounce, which is the lowest point it has touched since definite records were established. Thereafter the price rose gradually to about $1.00 per fine ounce in May, 1918, and maintained that level during a year of United States governmental regulation. In May, 1919, a rapid advance began which carried the price to the record high point of \$1.37½ in November, 1919. The average monthly price in January, 1920, was the highest ever recorded, but in March a sharp turn downward occurred, and silver fell to 80 cents on June 15th. Thereafter the price rose until a figure over \$1.00 was reached on August 20th. Decline again set in and before the end of the year foreign silver was quoted on New York market at 76⅛ cents an ounce.

A money metal which sells at \$1.37½ per ounce in January, at 80 cents in June, \$1.01¾ in August and 76¼ in October, may be considered an economic curiosity, even in a year of such wild fluctuations as these of 1920. If, for example, the American silver dollar had been the actual standard of value for the United States currency, its bullion value would have moved from \$1.06 to 62 cents, back to 78¾ cents, and down again to 59 cents, which would fairly rival the vicissitudes of the German mark.

11. *Effects on Eastern exchange.*—The decline in the price of silver has naturally had an effect on the Eastern exchanges. China in particular suffered in this movement, and there is little doubt that a number of Chinese financiers who were speculating in silver sustained huge losses. Taking three dates for which quotations are available, we find that on February 16th, 1920, when the price of silver in the London market was 83⅛ pence, the value of the Shang-

hai tael was 9 shillings and 3 pence in London; on March 24th, when the price of silver had fallen to 71½ pence, the value of the tael had also fallen and it was worth only 7 shillings and 5 pence. The decline in the value of the tael kept pace with the decline in the price of silver, until on June 9th, when silver had fallen to 45⅝ pence, the tael had fallen to 4 shillings and 10 pence.

12. *Silver melting points.*—The relation of the so-called melting points of silver coinage to international exchange has been clearly demonstrated during the reconstruction period. All nations use silver as subsidiary money and, with the exception of the United States silver dollar, all such coins are token money. With silver at its pre-war price the token coins of Europe and America were worth more as money than as commercial silver. This condition was the result of deliberate intention of the governments. The United States silver dollar was the one exception. It was designed to be a *standard* coin, not a *token,* and therefore contained an amount of silver (at the old price) that very closely approximated its face value.

As the price of bullion silver rises all these well planned schemes are disrupted. When silver sells for 73⅓ pence per ounce in London, all British silver coins are worth as much as commercial silver as they are as money. If the price of the metal goes higher, it will pay to melt small coins and sell the bar silver. Consequently 73⅓ pence per ounce is called the "melting point" for British silver coins. In the United States the melting point for token coinage is \$1.38 + per ounce for silver and that of the standard silver dollar is reached when \$1.29 + per ounce can be obtained for the metal.

As the price of silver rose in Europe during the war, because of the insatiable demands of the Orient, both England and France were forced to put embargoes on its exportation. This, however, failed to produce the desired result, for the price of silver went far beyond the melting points and subsidiary coinage began to disappear at an alarming rate. The exchange rates which were adverse to Europe only accelerated this disappearance of silver from circulation. A pound sterling would purchase only, say 80 per cent of its normal value in New York, while a hundred francs would be worth only 50 per cent of their par value in dollars. On the other hand, the silver coinage of either country would bring in New York not only its full value as money, but a premium that grew to be of very considerable size as silver reached its highest prices. The greater the discount at which the European currencies were quoted, the more likely was silver to disappear. Silver coins had largely gone from circulation in Continental Europe in 1920 and the quantity in Great Britain was materially reduced. In the United States this effect of high priced silver was not felt, altho no doubt a good many silver coins were melted down during 1920. Canada protected her subsidiary coinage by reducing slightly its silver content and thus raising the melting point.

13. *Silver standard.*—The silver standard exists in a country where it is enacted by law that silver alone shall be legal tender and the measure of value. China, as we have already noted, is now the only country of commercial importance that retains the silver standard. This fact has not, however, altered the position of silver in the Far East. Gold standards are theoretically in force in Siam, French Indo-China, Straits Settlements, British North Borneo, The Federated Malay States, Sarawak and India, but silver is the only currency in use. Siam's gold standard coin is the dos (or ten tical piece), but none has yet been issued. The colonial government of French Indo-China fixes the rate of exchange between the piastre or dollar, and the franc, thus giving the colony the gold standard of France. The Straits Settlements, British North Borneo, The Federated Malay States and Sarawak all use the same silver currency, which is maintained in a fixed ratio to the pound sterling. In each of these countries the notes of the four Anglo-Asiatic banks circulate with considerable freedom, and in certain places are preferred to the local paper issues which are, nevertheless, well supported and wisely administered paper currencies. The domestic trade of these countries is regulated by the bullion price of silver, but all outside transactions are based on gold, and in the end the value of silver is thus regulated by these international transactions.

The following are the principal coins used in these countries:

Name	*Fineness*	*Grammes gross*	*Grammes fine*
British Dollar	900	26.9569	24.2612
Mexican Dollar	902.7	27.073	24.4388
Maria Theresa	833 1/3	28.0668	23.3889
Straits Settlements Dollar	900	20.2177	18.1958
Indo-China Dollar (or piastre)	900	27.000	24.300
Chinese Republican Dollar or "Yuan"	900	26.8567	24.171
India Rupee	916 2/3	11.664	10.692

Maria Theresa Dollar. This is a trade coin (one without the obligation of redemption) minted at Vienna, but not used in Austria. It is current with full legal tender value in Abyssinia, Arabia, East Coast of Africa, Eritrea, Oman, Persian Gulf countries, Tripoli, and countries of the Eastern Mediterranean and Asia Minor. This coin has almost disappeared from Far Eastern circulation since 1914.

Mexican Peso.—This coin, also called "Mexican Dollar," is full legal tender in Hongkong and China. It is preferred by the Chinese to the coins minted by themselves.

British Dollar.—This coin was created in 1894 in response to the great demand for currency in the Far East. It is legal tender in Hongkong and Labuan.

Indo-China Piastre.—This coin was introduced by the French Government to help commerce in her Asiatic colonies. It is modelled after the Mexican dollar, and is accepted as equivalent to the latter coin.

Straits Settlements Dollar.—This coin was originally minted for circulation only in the Straits Settlements, but has become current in British North Borneo, The Federated Malay States and Sarawak. It has a fixed value of 2 shillings and 4 pence and is only given here for purposes of comparison as the Straits Settlements are on a gold exchange basis.

Trade Dollar.—This dollar was coined by the United States to compete with the Mexican dollar in trade with China and the Far East. It had no status within the United States and has been withdrawn from circulation. Any still outstanding have only a bullion value.

14. *Eastern exchange.*—In all these countries we are now considering, exchange is either regularly quoted, or can be negotiated, on the following countries or cities: Great Britain, France, Spain, Hong Kong, Singapore, New York, San Francisco, Vancouver, Japan, Shanghai, Amoy, Saigon and India. For many years the rate for telegraphic transfer on London has governed the rates on "sight" and "4 months' sight" bills common in the East. This custom may still be regarded as in force, tho the rate of telegraphic transfer on San Francisco or Vancouver, has within the last couple of years exerted an influence on the general rates.

15. *Currency of China.*—China is the oldest and most important of the silver standard countries and the ancient unit, the tael or liang, continues to be used. A tael is actually a weight and not a coin and circulates in the form of shoes,[1] or of small bars. This

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[1] From resemblance in shape to a Chinese woman's shoe.

unit is not fixed in any way. In different cities and provinces it varies in weight and in fineness of silver. Actually there are no silver ingots of one tael; the ingots usually weigh from 7 to 10 taels and are called sycee from the Chinese "Sai ssu," meaning fine silver.

The variation in weight in the sixteen best known kinds of tael is from 37.5317 grammes of fine silver in the Hai Kwan tael to 34.0732 grammes fine in the Swatow tael. The Hai Kwan (or customs) tael is the most important. It is generally rated at 72 per 100 Mexican dollars. The official tael agreed upon by treaty is the Kuping or Treasury tael divided into 100 cents of 10 mills each. This unit weighs 37.313 grammes .980 fine and contains 36.56674 grammes of fine silver. The Chinese monetary system has been still further complicated by the series of revolutions the country has been passing thru. There have recently been issued four different mintings of republican dollars weighing 26.8567 grammes 900 fine. The Mexican dollar also circulates freely. Many of the silver coins are stamped or "chopped." This practice arose from the fact that many light and debased coins were formerly in circulation, and having once established the value of a coin the Chinese merchant or banker marked it, not only that he might recognize it again but so that others to whom his "chop" was familiar might accept it confidently. The result of much chopping has been to mutilate and debase a very considerable part of the silver coinage in circulation.

Like the tael, the mace and candareen are simply denominations representing certain fixed weights of silver. The weights and value vary according to the location. All domestic business is transacted in "cash," a coin of varying weight, size and metals contained, but of fairly constant local value, which is officially considered to be at the rate of about 1000 to the United States dollar.

The value of the various taels moves with the price of silver, and it is impossible to give a fixed equivalent, but it is easily ascertained by multiplying the amount of fine silver in the tael by the price of an ounce or a gramme of fine silver. The Shanghai tael weighs about 1 1-6 ounces of standard silver (.925 fine). The Kuping tael, for instance, weighs 1.175625 ounces of fine silver.

The monetary system established in Hong Kong and Labuan by the British Government is silver standard and has as its base or standard coin the Mexican dollar weighing 27.073 grammes (902.7 fine) or 24.4388 grammes fine silver. The British dollar (24.2612 grammes of fine silver) is treated as equal to the Mexican dollar and both are legal tender to any amount.

16. *Chinese exchanges.*—From the foregoing facts it may easily be surmised that the operation of exchange with China is a complicated matter, and is best dealt with by those who have made a life study of the East and its customs. The rates of exchange rise and fall with the price of silver, and owing to the

violent variations in these rates the business is a highly specialized one. Quotations and drawing facilities on the Orient are usually provided by one of the Anglo-Asiatic banks. Rates for all the customary forms of bills are governed by those of telegraphic transfers on London. The latter are arrived at by a computation based upon the degree of fineness of bar silver imported into China in comparison with that of British standard silver.

The usual forces of supply and demand for bills of exchange exert the same pressure here as elsewhere and rates are consequently "at, above, or below par." It works out, therefore, that this expression as applied to Chinese exchange refers to the cost at which silver can be bought in London or New York and delivered in Shanghai, all charges included.

REVIEW

Why cannot a mint par of exchange be computed between a gold using and a silver using country?

What effect has the gold price of silver in the exchanges?

Discuss the advantages and disadvantages of the silver standard.

Describe recent variations in silver prices and discuss their causes.

When does a rising price of silver menace the subsidiary coinage of gold standard countries?

CHAPTER XII

FIAT OR IRREDEEMABLE PAPER MONEY

1. *Money and the war.*—The war plunged the leading commercial nations of Europe into a chaos of inconvertible paper money, comparable to that of the French Revolution, when a washerwoman was not even decently paid unless her homeward load of paper "assignats" filled the basket in which she had carried the laundry to her customer. As a result of the excessive issues of bank and government notes gold disappeared from circulation in the belligerent countries of Europe, and the gold value of the paper money depreciated, until a paper pound had fallen in its gold value from $4.86 2/3 to $3.20, the French franc from 19.3 cents to less than 7 cents, and the German mark from 24 cents to less than 2 cents, while the value of the Russian rouble, nominally about 50 cents, reached the vanishing point.

The well known English economist, Professor Edwin Cannan, in the introduction to "The Paper Pound of 1797-1921" (published in 1919) makes the following interesting comment on the depreciation of the paper currencies of Europe after 1914, as compared with the depreciation of the paper pound sterling during the Napoleonic Wars:

In the comparatively short war of 1914-18 currencies "not convertible at will into a coin which is exportable" (*Report*, p. 17) were issued by Governments and Government banks in amounts compared with which the 100 per cent increase in thirteen years, which made the Bullion Committee complain so vigorously in 1810, looks absolutely trifling. The British Government brought out an entirely new issue of £1 and 10s. notes and increased it to 293 millions at the date of the armistice: the Bank of France increased its issue from 6,000 million francs to 30,500 millions: the Italian increase was from 2,500 millions to over 8,000. The precise increase in Germany and Austria-Hungary is obscure but understood to have been much greater. The record since the armistice is still less of a kind to give the present day Europeans ground for boasting themselves better than their fathers. In twenty-three weeks the British Government had increased the note issue by 59 millions more, and the total still stood on October 1, 1919, at 335 millions. The French issue on October 2 was 36,250 millions, the Italian in July, 1919, was about 10,000 millions and the Russian rouble is being manufactured in numbers which suggest astronomers' calculations rather than anything terrestrial.

The result is what Horner and the Bullion Committee feared. The pound in October 1919 will buy just about the same amount of gold as it would when the Bullion Committee sat in 1910, that is, about 107 grains instead of the normal 123¼, but it is respectable compared with its colleagues in Europe: the franc will buy about 3½ instead of nearly 5 grains: the case of the lira is rather worse; the mark will buy little more than 1 grain instead of 6; the Austrian krone and the Russian rouble are worse. Politicians have certainly egregiously failed to "advert to the foreign exchanges and the price of bullion in regulating their issues": instead they amuse their ignorant subjects with fantastic explanations of the perversity of the exchanges and chimerical schemes for "correcting" them by stopping imports or borrowing still more from abroad.

No one can contend that these paper standards are superior to the gold standard. In the first place they are all different, and in the second the one common property that they possess in all making prices much higher than they would be if paper and gold had not diverged, marks them as all inferior. Gold has been produced in almost the usual quantities thruout the war, it is almost alone among metals in not having been used in the manufacture of munitions of war, and it has been thrown out of currency use over a wide area. Consequently it is greatly depreciated as against commodities: that is, 123¼ grains of gold or any freely exportable gold coin will buy far less of ordinary commodities than before the war—perhaps scarcely half. Consequently each of the particular local divergencies between paper and gold simply constitutes a local aggravation of a world-wide rise of prices, a great part of which is itself produced by the general introduction of the paper currencies.

When the scales at last fall from the eyes of the people of Europe, groaning under the rise of prices they will no longer cry to their Governments: "Hang the profiteers!" but, "Burn your paper money, and go on burning it till it will buy as much gold as it used to do!"

2. *Trade on a paper basis.*—If a country has no gold, and can therefore export none, can it possibly engage in trade with other countries? The same question might be asked with regard to a country the Government of which has placed an embargo on the export of gold. How, the reader might reasonably ask, settle an adverse balance of trade?

To answer this question intelligently the reader must understand clearly the fundamental principles of foreign trade and foreign exchange. He must perceive clearly the truth of these two statements:

First.—All foreign trade is essentially of the nature of barter, a nation's exports of goods necessarily being equal in value to its imports.

Second.—The so-called balance of trade, which is settled by a shipment of gold when the trade is between gold standard countries, is not a real balance and may be wiped out by the shipment of commodities other than gold.

Countries on a paper basis, not having any gold or not being willing to ship any gold, settle or pay the so-called balance of trade by larger exports of commodities. Essentially the foreign trade between a country and other countries is an exchange of equal values and these values may be represented by commodities in general or by gold and silver.

Let us suppose there is trade between a country on a paper basis and one on a gold basis. Evidently the exporters in the gold country will not be willing to take their pay in the money of the paper country. If then the people of the paper country import more than they export, how can they possibly pay the balance since, we will suppose, their country contains no gold.

They will pay that balance by an increased export of commodities and for this reason: Since the imports in the paper country, as we have assumed, have been larger than the exports, there will have been a strong demand for exchange on the gold country and the banks in the paper country or the dealers in exchange will have raised their rates for gold exchange. These higher rates of exchange will be equivalent to a rise in the prices of goods imported from the gold country and therefore will tend to lessen the tide of imports. At the same time in the gold country the price of exchange on the paper country will have fallen in a corresponding degree, and hence have encouraged imports from the paper country.

Of course a country on a paper basis lacking a supply of gold could not conveniently engage in foreign trade unless its bankers maintain balances to their credit in gold standard countries. They create and maintain these balances not by shipments of gold but by shipments of bills of exchange drawn by their local customers on the gold standard country. These bills have their origin of course in the exports of merchandise from the paper country to the gold standard country.

The foregoing analysis should enable the reader to understand why the United States, a country on the gold basis, has been able since the war to carry on an enormous foreign trade with the great commercial nations of Europe which are now upon a paper basis. It should enable him also to understand the significance of a decline or of a rise in the quotations of the pound sterling and the French franc. A decline of sterling in the New York market, for example, indicates an excess of exports from the United States whether of goods or of securities, and at the same time it indicates a lower cost to Americans of English goods and securities thereby stimulating an increase of imports from Great Britain. A rise in the New York quotation of sterling exchange naturally has the opposite effect.

Given the characteristics of irredeemable paper money which have been described it will be readily understood that no nation willingly puts its feet into the mire of fiat money. They are dragged into it sometimes by mistaken nations of finance, more frequently by some national emergency.

3. *Fruits of war.*—Among the more progressive nations, such currency is often one of the fruits of war. Thus the United States lost the metallic basis of its currency during the Civil War, and Great Britain was forced to a paper pound during the Napoleonic struggle and in the Great World War. The significance, then of the discussion of paper money lies in the fact that Europe groans under a paper currency, and that most of our trade is done at the present time with nations on a paper basis.

A few months after the beginning of the Great War, the European demand for American products grew rapidly and exports began to outstrip imports. Exchange which at the first outbreak of hostilities had risen to unapproached heights, began to fall and sterling exchange fell below par. By the issue of the Anglo-French loan and the extensive credits granted by the American Government, Great Britain during the war period was enabled to hold the rate at approximately $4.75 to the pound sterling. It was to her advantage to do so both to avoid the depressing moral effect of a low rate of exchange, and to make better bargains in the purchase of goods. In the language of the day sterling exchange was "pegged" at $4.75 per pound, French exchange at about 9 per cent below par and Italian exchange at about 18 per cent below par.

4. *Current exchange rates.*—After the armistice foreign governments withdrew their support of the exchange rates and they fell rapidly. Rates for February 19, 1921, are quoted in the following table:

Country	Par	Feb. 19, 1921	Per cent Depreciation from Par
England	$4.8665	$3.8525	20.8
France	.193	.0710	63.2
Italy	.193	.0364	81.1
Spain	.193	.1390	28.0
Germany	.238	.0159	93.3
Switzerland	.193	.1648	14.6
Sweden	.268	.2220	17.2
Holland	.402	.3425	14.8
Belgium	.193	.0741	61.6
Argentina	.4244	.3511	17.4
Japan	.498	.4838	2.9
Canada	1.000	.8656	13.4

The leading nations of Europe are as shown by the depreciation of their currency in exchange with a gold using country for the time being on a paper basis. It is a concession to national sensibilities to call their present status a suspended gold standard. It is a concession which may be most willingly made if it implies that the suspension of gold payments will soon be removed by a return to convertibility of the monetary circulation.

The difficulties of exchange with paper using countries rest upon the absence of the automatic regulation of rates which is insured by the free movement of gold, and the more or less violent fluctuations in the rates which result from internal currency conditions. It is not contended that paper money even tho irredeemable, may not if carefully guarded maintain a relative stability of value, and a reasonably even course of exchange. But it is to be remembered that such steadiness if attained rests upon the wisdom of governments, and is a less certain reliance than the automatic workings of the laws of trade.

The problems of exchange with paper money countries can perhaps be better explained by reference to some that have long been on such a basis than by considering those in which irredeemable paper money is a recent affliction, complicated by the after effects of a great world struggle.

5. *Paper currencies.*—The modern exponents of paper money currency have been chiefly among the South and Central American republics. A number of these countries, altho they have established a theoretical gold basis for their currencies, have been for a long time embarrassed by large quantities of inconvertible paper money. During recent years, both before and since the Great War, strong efforts have been made by the more progressive of those countries to put their currencies and finances upon a sounder basis. Venezuela, Uruguay, Peru, Ecuador, Costa Rica, Honduras, Bolivia and Salvador, have all made

progress towards this desired end. All of these countries are now regarded as having Gold Exchange Standards. Salvador in 1920 became an actual gold standard country, her recent financial history being somewhat similar to that of Columbia. Hayti, which formerly belonged in the theoretical gold standard group, is rapidly approaching a complete rehabilitation of her currency system. The entry of American bankers and of American Government influence into the financial problems of that republic is having a salutary effect.

6. *Paper money as a standard.*—We are not concerned in this chapter with paper money as such, but only with paper currency which has become a nation's standard of value. Convertible paper money has performed a very useful function in the circulation of most modern countries. So long as it is freely convertible into gold on demand, its presence in the circulation does not in any way affect the existence of the gold standard.

An issue of paper money not supported by an adequate gold reserve, is sure to prove a curse in the long run, as all countries that have tried it have found. When a paper issue is called upon to represent in purchasing power a larger quantity of gold than that for which it will be redeemed in specie upon demand, it at once takes on the aspect of a non-interest bearing loan which has been forced upon a public by its government. The natural consequence is that the more of it there is issued, the less probability there is of its ultimate redemption. Conditions of this sort always produce depreciation to a dangerous degree.

Depreciation means that the purchasing power of the currency as compared with that of gold has fallen. If it requires, for instance, 225 paper dollars to purchase 100 gold dollars, gold is at a premium of 125 per cent and paper money is at 44 4-9 per cent of gold or at a discount of 55 5-9 per cent; or again, 300 per cent premium means that for 100 gold dollars one would have to give 400 (300 plus 100) paper dollars.

In this connection the following problems will be found helpful:

(1) The premium on gold is 30%; at what per cent discount is paper money?

Solution: $\frac{300 \times 100}{300 \text{ plus } 100} = \frac{30{,}000}{400} = 75\%$ discount.

(2) Paper currency is at a discount of 75% as compared with gold; what is the premium on gold?

Solution: $\frac{75 \times 100}{100 - 75} = \frac{7{,}500}{25} = 300\%$ premium.

7. *Results of depreciation.*—Following the course just outlined, depreciation may proceed to an extent that practically paralyzes the business of a country. As the process continues, all metallic money disappears from circulation, even tho there may be a strong tendency for minted coin from neighboring countries to find its way in. As depreciation progresses all goods offered for sale by merchants are quoted at two prices, a silver or gold price, and a paper money price. No more striking example of the breakdown

of a paper currency has ever been afforded than the return to conditions of barter which took place in Austria during the latter part of the war. The following statement by Countess Szechenyi gives a concrete illustration of this phase:

> "During Bela Kun's reign of terror, which lasted from March until August . . . men, formerly well off, to obtain food would get together remnants of old clothes, perhaps an old pair of shoes, resoled for the tenth time, and a ragged shirt, and walking out into the country would sit down in the market place of some small town and wait for the peasants to come and inspect their wares. These latter were doing their best to starve out the city and to them any one from there was a 'dog of a socialist,' so they bargained to the utmost, and if a man got two eggs for two shoes, and a spoonful of lard for a shirt, he was lucky—and he had that to take back to his children."

The deliberate destruction of all currency values in Russia may also be cited as an example. Travelers from that country reported late in 1920 that a very ordinary dinner cost the startling sum of eight million rubles in paper money. It is evident that such money had become nothing more than a method of counting, and bore little connection with any standard of value. Inconvertible paper money has no intrinsic value and its gold value depends entirely upon the amount of gold that the public of the country is willing to give for its own paper unit. This, quite as often as not, depends upon political conditions and not upon the factors of international trade.

8. *Chile.*—For many years Chile has been com-

mercially the most important of the paper standard countries. An illustration of the vicissitudes of a country in progress from a paper to a gold exchange standard, the following description of the monetary system is quoted:[1]

> Chile's monetary system has gone thru numerous vicissitudes since the establishment of the Republic. It must suffice to say that since 1898 the bulk of Chile's currency has consisted of inconvertible paper money. The Chilean peso has a gold content of 0.5991 gramme of gold, 0.916¾ fine, or 0.54918 gramme of pure gold, and is worth at par 36.5 cents, or 18 pence sterling in British currency, in which it is generally quoted. The different kinds of currency in circulation in Chile at the end of each year from 1912 to 1920 are shown in the table below:

CHILE'S FIDUCIARY NOTE CIRCULATION, 1912-1920

(In 1,000 pesos.)

	Fiscal notes						
	Ancient Series	Fixed issue	Conversion office issues	Total	Treasury notes	Guaranteed bank notes	Total note circulation
Dec. 31, 1912....	875	150,000	18,482	169,357	3	1,545	170,904
Dec. 31, 1913....	873	150,000	33,822	184,696	3	1,343	186,041
Dec. 31, 1914....	854	150,000	45,000	195,854	28,136	990	224,980
Dec. 31, 1915....	853	150,000	12,054	162,907	13,827	977	177,712
Dec. 31, 1916....	853	150,000	18,145	168,998	8,982	929	178,910
Dec. 31, 1917....	853	150,000	24,898	175,752	9,482	928	186,162
Dec. 31, 1918....	853	150,000	70,588	221,441	5,320	927	227,688
Mar. 17, 1920....	853	150,000	47,878	198,741	28,587	927	226,466

> A small amount of notes of ancient issues are in circulation, but the principal item is 150 million pesos of inconvertible paper notes generally known as the fixed issue. In addition to this, there is a conversion office, at which certain authorized banks may obtain paper money

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[1] *Federal Reserve Bulletin* for October, 1920.

at the rate of 1 peso for 12 pence deposited in gold, these notes being redeemable on demand in gold. A law in 1918 authorizes another type of convertible notes at 18 pence per peso, but this being greatly in excess of the exchange value of the peso no use has been made of this provision. There is also an issue of treasury notes, largely the result of emergency legislation in 1914, when the Government issued notes to assist the industries, chiefly the nitrate industry, during the crisis caused by the war. These notes are supported by obligations of the industries assisted. The amount outstanding, which in 1914 was about 28 million, declined to about 5 million in 1918, but owing to the depression in 1919 it increased again, and in March, 1920, stood at about 29 million pesos. The Government is also liable on a small amount, less than 1 million, of notes issued by banks at the time when they had circulation privileges, since taken over by the Government. It is generally considered that these notes have been lost or destroyed and that this liability is a nominal one. In the aggregate, the note circulation of Chile has shown comparatively little growth during the war period; from 225 million in 1914 it declined to 178 million in 1915; then rose gradually to 251 in 1919, and declined again to 226 million by March, 1920.

Currency other than the so-called fixed issue is largely taken care of automatically, either by the treasury or by the conversion office. In the case of the fixed issue, there has been a fund accumulated in gold that is sufficient to effect conversion. This fund was built up largely under the operation of a law of 1909 by which not less than one-half million pesos per month were deposited in the treasury or in specified banks abroad out of receipts from the gold export duties. In 1914 this fund amounted to 108 million pesos at 18 pence per peso; on October 31, 1919, the latest date for which figures are available, the fund was about 113 million pesos. A table showing the distribution of this fund is attached. It will be noted that in 1914 the larger part of it—74 million—was in England,

and 30 million was in Germany. The gold was transferred from Germany to Chile thru the sale by Germany of part of her stock of nitrates to America; that is, the Germans paid off their gold debt to Chile by transferring nitrates to Americans, and the Americans sold the nitrates to the Allies for gold, which was ultimately shipped to Chile.

CHILE'S GOLD CONVERSION FUND, 1910-1919

(In 1,000 pesos gold at 18 d.)

Year	*In the treasury*	IN FOREIGN BANKS				*Total*
		England	*Germany*	*United States*	*Total*	
1910	......	9,123	85,360	......	94,483	94,483
1911	......	9,442	88,577	......	98,019	98,019
1912	......	9,773	91,915	......	101,688	101,688
1913	......	10,115	95,379	......	105,494	105,494
1914	3,644	74,261	30,256	......	104,517	108,161
1915	3,644	80,263	27,128	......	107,391	111,034
1916	3,644	58,766	22,226	3,125	84,116	87,760
1917	24,765	54,748	2,721	11,911	69,380	94,145
1918	64,146	47,054	62	10	47,126	111,272
Oct. 31, 1919.	66,667	45,788	......	10	45,798	[1] 112,610

Since the cessation of hostilities a considerable portion of the gold has been returned to Chile and at the present time the bulk of it is in the treasury, and nearly all the remainder in England. It should be noted that at every date shown in the table the conversion fund was sufficient to redeem the inconvertible notes at 12 pence per peso, which was considered a fair figure in view of the prevailing rate of exchange, and to leave a balance to the credit of the treasury. On October 31, 1919, for instance, there were 112,610,000 pesos at 18 pence per peso in the conversion fund. This amount would redeem 168,916,000 pesos at 12 pence per peso, i. e., it would redeem the outstanding 150 millions, and leave a balance of about 19 million pesos. The fact that redemption was not effected is traceable to an economic and political controversy which has been waged in Chile for more than a generation. . . . In 1909 there was an agitation for conversion, but the Parliament instead passed a bill establishing the foreign conversion fund, a measure which was vetoed by the President and passed over his veto. Conversion has constantly been postponed, the latest postponement being for six months after July of the current year (1920).

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[1] Including 145 thousand pesos classed as miscellaneous.

As a consequence of the instability of the exchange rate and of the value of the paper currency, it is not uncommon in Chile to make bank deposits in terms of pounds sterling and more recently of dollars and to issue checks against them, so that there is a considerable circulation of bank credit expressed in foreign currencies.

REVIEW

Describe rise of irredeemable paper money in Europe.
How is trade carried on with paper using countries?
What is the present status of exchange with leading nations?
Describe effect upon values of an over-issue of paper.
Summarize exchange conditions with Chile.

CHAPTER XIII

NEW YORK AND LONDON AS FINANCIAL CENTERS

1. *New York's prominence in world finance.*—The Great War in Europe, besides making the United States a creditor nation, threw upon New York City, its financial centre, a great burden of financial responsibility and gave rise to the belief in many quarters that New York City was destined to be henceforth the world's financial centre. For several centuries before the war, London had admittedly been the centre of the world's financial operations. Is it possible that New York in the near future, because of the advantage given her by the war, may wrest the title from London and hold it for centuries to come?

2. *What makes a financial centre.*—Many circumstances have combined in the past to give London its supremacy in finance. Its geographical position midway between the eastern and western markets, its exports and imports carried in English bottoms to and from all the world's ports, its sound monetary system, a sterling bill for a century having been regarded as the equivalent of gold, its liquid discount market, its relatively low and stable rate of interest, its large investments in foreign countries and the high reputation for business honor and square dealing en-

joyed by English bankers and traders thruout the world, were among the most important circumstances that contributed to the making of the sterling bill practically equivalent to a world medium of exchange.

Of the circumstances mentioned in the foregoing paragraph at least three are absolutely essential.

First.—No city can become or long remain the world's financial centre unless it is in close commercial touch with practically all the nations of the earth.

Second.—Its monetary system must be firmly established on the gold basis and offer the world a free gold market.

Third.—It must have a liquid discount market.

Any city possessing these conditions will always be a dangerous rival of London even tho the latter city as the years go on regains the supremacy lost during the war.

And any city possessing these fundamental advantages will, as it gradually acquires leadership in world finance, at the same time acquire the diversified and freer banking system, the high credit standing with foreign nations, numerous branches in foreign countries, and the large mercantile marine for which England has been noted in recent centuries.

3. *Finance follows trade.*—The old saying that trade follows the flag does not express so important a truth as the statement that finance follows trade. New York is the financial centre of the United States and Canada because it trades directly or indirectly with all the merchants of these two countries. In

every community of the United States and in most of the towns and cities of Canada will be found men who have bought goods from New York or who are shipping commodities to New York. Those who are shipping to New York receive New York exchange in payment and sell it to their bank. Those who purchase goods or securities from New York buy New York exchange from their local bank and send it to their New York creditor. As has been already explained in earlier chapters of this book, New York exchange, because of New York's commanding position as a trade centre, has long been the financial center of the country. The powerful banks in New York did not make it the financial center. On the contrary, they are themselves the natural and necessary or inevitable products of New York City's enormous trade with the interior.

In a similar way and for similar reasons London became the world's financial center. England's insular position with a territory able to support only a comparatively small population compelled her centuries ago to become the world's workshop, importing raw materials from all quarters of the globe and exporting them in a great variety of manufactured articles, most of them famous for their honest workmanship. Her business leaders encouraged the building of ships because they wanted proper markets for English wares, and freedom of trade, first advocated by Adam Smith in 1776, was adopted by England early in the last century because it was recognized that exports and imports must increase together and that taxes on imported raw materials increased the English manufacturer's cost and tended to place him at a disadvantage with foreign competitors.

It is doubtless true that England might not have gained her enormous world trade and her financial leadership had she not in the beginning encouraged shipbuilding and sent her flag into the harbors of all the seas. Yet the essential cause of her leadership in finance was her world trade and not her great merchant fleet.

4. *World exchange must mean gold.*—It is common knowledge that people are perfectly willing to accept paper money or checks and drafts in payment for the goods they sell, provided they are quite confident that this paper can be exchanged for gold if desired, and so long as such confidence prevails nobody thinks of asking for the gold. But nobody wants anything to do with a promise to pay which is tainted with uncertainty. Such paper can get into circulation only at a discount.

So no city can become a world leader in finance unless merchants and bankers are everywhere convinced that drafts on that city will be promptly met and paid in gold. If thruout the world there is distrust of its monetary or banking system, it cannot become a world financial centre no matter how great its exports and imports. England before the war had long been on the gold basis and London had long been the world's freest gold market. Sterling bills of exchange were bought and sold in the United States, in China, in South America and in all other countries where trade had risen above the level of barter, and every buyer had absolute confidence that his bills could instantly be exchanged in London for gold, or be used for the payment of debts in London quite as effectively as gold itself. The War however threw England off the gold basis just as did the Napoleonic Wars over one hundred years ago and London immediately lost its world's supremacy in finance.

5. *Liquid discount market.*—The reader will have learned from the volume on "Banking" that it is practically impossible for a country to possess a discount market unless its financial operations are stabilized and supported by one or more very powerful banking institutions, and that in most of the countries of Europe such markets have been built up because of the existence of large central banks, many of them government owned or controlled. The Bank of England, established in 1694, is privately owned and controlled, but it enjoys certain exclusive privileges which compel it in self defense to assume all the responsibilities of a government bank, so that within certain limits it has become a regulator of the London money market and a source of relief to London banks in times of stress. Hence London before the War had developed the most sensitive and liquid discount market in the world. Bills and securities of all kinds found in London a readier market than in any other city. It was the world's market for capital. In that

city one found the greatest lenders and the biggest borrowers. To convert a bill of exchange into gold was as easy as it is to cash a check in an American bank.

6. *New York's advantages.*—It is clear that London has lost for a time its commanding position in finance, for a sterling bill and paper pound no longer mean a definite quantity of gold. During and since the war the gold value of the paper pound has fluctuated so rapidly and violently that few people have any idea what the quotation will be tomorrow, to say nothing of next week. For example in the year 1920 sterling exchange varied from \$3.19 to \$4.06 2/3 and in the two months of January and February, 1921, between \$3.53¼ and \$3.92. So long as there is possibility of such fluctuations in the future, or to be more exact, so long as the paper pound is not redeemable easily and promptly in gold of the prescribed weight and fineness, it is certain that London cannot regain its supremacy and that New York will keep the leadership in finance.

New York now possesses two of the conditions essential to leadership, namely, a sound monetary system on the gold basis together with a free gold market, and a federal banking system that is rapidly developing a liquid discount market. Unhappily the foreign trade of the United States in the past has not only been carried in foreign ships but has not had a world wide distribution. The bulk of our exports before the war went to Europe, and some of our exporters were not always conscientious in their efforts to have their goods correspond honestly with specifications and promises. Furthermore, during the last century we indulged in some financial and monetary experiments which made many foreigners suspicious of our financial sanity. For these reasons in some of the world's market places and banking circles "dollar exchange," as drafts on New York are called, are looked upon rather dubiously. If New York is to hold its newly acquired leadership, no effort must be spared to win foreigners' confidence in America's determination to maintain the gold standard, in the honesty of American manufacturers, in the fundamental soundness of our banking system and in the absolute freedom of our gold market. Even then New York may lose out in the race with London as soon as England gets back on the gold basis, if unwise legislation hampers the growth of American shipping, or if high tariffs raise the costs of American products and arouse resentment in the bosoms of our best customers.

As a creditor nation the United States must in the not far distant future become a heavy importer of foreign made goods. To many Americans this prospect is not pleasing, and there is little doubt that it will be the subject of much debate during the coming years. In this connection we can be certain about one thing, namely, that New York City cannot long remain a world center in finance if ships laden with the world's goods do not find a welcome off Sandy Hook.[1]

7. *Physical conditions favorable to London.*—London is situated on the threshold of Europe in the heart of the world's commercial activities, directly opposite the estuary of the Scheldt and nearly opposite that of the Rhine, and is within a short distance of every important exchange center in the world with the exception of New York. This may be considered as an almost insuperable obstacle to New York's ambition.

London has the advantage of water lanes free from ice and fog to every large port in the world with the exception of New York; the climate is equable and liquids and perishable goods run little or no danger of freezing in winter.

The restricted insular area of Great Britain, a little larger than the State of Minnesota, is also an important factor, as it not only affords an immense seaboard compared with its size, but concentrates the population. A frequent and rapid transit service makes Great Britain practically one large city with London as the business center. Every bank in the country has a branch or correspondent in London, carries its reserves there and clears direct with every part of the country thru its London agent. The economy of resources effected by this natural concentration of funds is seldom realized and is worthy of study. The insular position of London renders it comparatively free from the danger of invasion and seizure by a hostile power and this immunity has been a factor in making London a world depository.

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[1] The remainder of the present chapter is taken by permission from an article by Mr. E. L. Stewart Patterson, published in the Annals of the *American Academy of Political and Social Science,* November, 1916.

8. *Mail and cable facilities.*—The geographical situation of Great Britain, coupled with her willingness to invest money in international utilities, has placed her in a unique position as regards mail and cable facilities. Thru her immense mercantile navy, London has direct communication by fast steamers with every important port in the world and consequently acts as a foreign mail clearing house for all other countries. If French, German or Dutch steamers afford a faster service to any point they can be utilized with little or no loss of time.

As Great Britain owns and operates two-thirds of the submarine cable mileage of the world, it is natural that London should be a great cable center with practically direct communication the world over. This service is now supplemented by a far flung system of wireless stations. Furthermore, under normal conditions, every main railroad on the continent of Europe gives its best service and equipment to its London mail train. The Trans-Siberian Railway already gives access by rail to the Pacific and it is only a question of time before thru connections with India, China and South Africa will be established.

9. *Time advantages.*—In dealing in foreign ex-

change and stocks London is the center of the world as regards time. She knows the conditions in eastern markets before they close and is open long enough to operate in New York before her own markets close. Her position is therefore pivotal as regards time and distance. Time is the essence of an exchange transaction; a day's delay may turn a profit into a loss and, granting that New York has the means and enterprise to create an efficient steamship and cable service in due course, how can she eliminate the more serious handicap of distance by water from all other financial centers?

10. *National characteristics.*—Great Britain is a land of slowly acquired fortunes, and the banker and merchant there are content with small profits and slow returns. They have long realized the fact that trade follows the loan and have, therefore, been willing to invest money in foreign countries with no prospect of recovering immediate returns or large profits. The financing of these loans abroad has been an important factor in making the London money market so supreme. It is doubtful if the American is adapted temperamentally for operations of this kind or for the small profits of the exchange operations connected therewith. The United States has still a vast area in proportion to its population, its natural resources are not yet fully developed and it is a country of large and rapidly acquired fortunes. It will, therefore, be many years before the investors and entrepreneurs are forced to direct their attention to for-

eign fields. Great Britain, before the war, invested over a billion dollars annually in foreign enterprises and at the beginning of the war had between twenty and thirty billions so invested. The United States at that time was a debtor nation for over six billion dollars, this amount was largely paid off or absorbed during the war, she had to invest nearly twenty-five billions before she could be on an equal footing with Great Britain in this connection.

11. *Willingness to seek fortune abroad.*—The average family of Great Britain is large compared with that of the United States and there is little room and few opportunities at home for the younger sons. This class of men finds its way into the army, the navy and the mercantile marine and go abroad as clerks, etc., to foreign and colonial banks and commercial houses. The more venturesome, as soon as they acquire experience, carry British trade and prestige to new and undeveloped countries—British subjects are found everywhere, no matter how remote the place.

The young American, on the other hand, has so many opportunities at home that there is little inducement to venture abroad except for pleasure. He is probably the only son of the family and takes up his father's business or is assisted in setting up in business for himself. If he goes abroad, he is not content with a subordinate position, but wants to be his own master and strike out for himself. Preferably he goes back to his home to do this. We might instance the experience of the International Banking

Corporation, a state bank, chartered in Connecticut with foreign branches chiefly in the Orient. This bank, tho an American institution, is manned principally by Englishmen. It will be interesting to watch the personnel of the staff of foreign branches of national banks established under the Federal Reserve Act.

12. *London's discount market.*—The natural complement of a free gold market is a liquid money market capable of absorbing bills of exchange to an almost unlimited amount. This unique feature of the London market makes a first-class bill of exchange on London as acceptable as gold. The strength and broadness of the London market, apart from the natural resources of the country, lie in the ebb and flow of foreign capital thru the machinery of the branches of foreign and colonial banks established there.

Altho London does not particularly encourage the establishment of foreign banks, it, on the other hand, does nothing to restrict the movement and allows freedom in banking privileges to all comers of good standing. This broad minded policy, tho it perhaps affects to a certain extent the individual interests of some of the British banks, is recognized as of great importance to London and the country in general, and therefore indirectly to the banks themselves. These branches of foreign banks, with their network of correspondents thruout the world, in addition to their direct influence on the exchange situation, give invaluable assistance to the Bank of England in preserving the equilibrium of the money market.

The policy of New York in connection with foreign banks is just the reverse of that of London and is apparently based on a local and narrow point of view. New York bankers have always discouraged the establishment of foreign banks in their midst and have evoked state legislation and other means to this end. A few foreign banks are represented by agents, not by branches. They cannot take deposits or discount commercial paper and their activities are practically restricted to making call loans and dealing in foreign exchange.

The London discount rates are controlled by a central institution, the Bank of England, and changes in the rate are not only infrequent but seldom rise above six per cent. By this control of the money market thru the bank rate, as it is called, the Bank of England has been able to attract gold to London by raising the rate whenever the exigencies of commerce and the exchange situation require it.

REVIEW

What is meant by a financial center?

Why is New York the financial center of the United States?

What are present advantages of New York in world finance?

What conditions gave London its supremacy? Distinguish between those which are permanent and those which resulted from historical development.

CHAPTER XIV

RESTORATION PROSPECTS FOR EXCHANGE

1. *Existing conditions.*—The frequent references to normal conditions made in this volume may give rise in the reader's mind to some question regarding the abnormal state of affairs that has been with us since the signing of the armistice in 1918. The treatment of the subject of foreign exchange cannot enter either into a history of war finance methods, or the interaction of the economic forces that has brought about the conditions of the reconstruction period. The evidences of severe economic disturbance have been apparent to all. High prices and speculation of the most undesirable kind, strikes and lockouts, embargoes and restrictions both in commerce and finance, scarcity of raw materials, even of the necessaries of life, up to the starvation point in some countries, while others held unsalable surplus stocks of these goods; these have been a few of the worst symptoms of the disease from which world commerce has been suffering.

Historians of war epochs have often expressed surprise at the recuperative power displayed by devastated nations. Greater thrift, more willingness to work, the restoration of gainful trade, the introduction of more efficient methods and high patriotic ideals applied to the payment of war debts, have never before failed within a few years to rehabilitate on an even more prosperous footing the broken commercial life of nations. In the present juncture there was perhaps too great a reliance upon the immediate effect of such recuperative forces. During the last quarter of 1920 the condition of the various foreign exchanges reflected a state of affairs that showed less improvement during the previous eventful two years than even the most pessimistic expectations had forecasted.

All regular exchange operations with a number of countries such as Finland, Roumania and some of the new states of Central Europe, had practically disappeared in so far as New York was concerned. London was trying to find some basis other than that of barter, pure and simple, upon which to establish business relations with such countries and was meeting with only slight success. Sterling and franc exchange in New York had gone down to startlingly low levels. The Italian and Greek exchanges reached so low an ebb that trade with those countries was almost paralyzed. The currencies of the former central empires were quoted at less than a tenth of their pre-war prices. Russian exchange was non-existent and all the countries that were neutral during the war saw the rates both in London and New York go steadily against them.

It must be borne in mind that owing to the operation of other forces, the exchanges failed to reflect the progress in world reconstruction that had been made up to the end of 1920. Industrially, Belgium had in the first two years of peace returned to about eighty per cent of her former productivity. Both in agriculture and industry France had shown splendid progress toward a new normal adjustment. In Great Britain the factories had almost all got back to peacetime conditions and British exports were increasing rapidly. Italy, after a period of strenuous readjustment between capital and labor was settling down to steady production, and Germany was working up all the raw material she could produce or obtain from the outside world.

2. *The position of New York and of London.*—During this period New York has played the new role of world creditor, and in a limited way that of world banker. During the stress and strain of war the capital accumulations of the United States were absorbed by her war needs and in lending aid and comfort to her allies. While this was going on new enterprises at home not connected with war activities lagged, and in the months since the armistice have made heavy demands upon the capital market. Foreign nations, municipalities and productive enterprises have had to compete in the New York market with this local demand. Yet the number of foreign securities listed on the New York Exchange continues to grow. With every disposition on the part of American capital to lend assistance to our recent allies in the work of rehabilitation it has been difficult for them to find

adequate security as a basis for credit. The exchanges have favored New York and this under normal conditions would have led to the export of goods and capital. But the exchange market lacks the automatic adjustment which arises from the free movement of gold, and since the exchanges depend in so large measure upon the depreciation of currency it is difficult to measure their exact significance.

London has occupied the unenviable position of being a debtor to New York and a creditor to all Europe and much of the rest of the world. Sterling has hovered between $3.45 and $3.75 in New York while at a premium on the continent of Europe. Great Britain has had to pay at an unfavorable rate of exchange for such articles of prime importance as wheat and cotton, and at the same time the rates from her best customer countries have been so unfavorable to them that the export of goods manufactured in the British Isles has been greatly hampered. All the former belligerent countries of Europe are deeply in debt to Great Britain. In London there has been real striving to find a basis for still further credits to the distressed nations. In the United States sincere effort has been made to accomplish the same purpose, notably the revival in 1920 of the War Finance Board and the creation by bankers and business men of the International Finance Corporation with a capital of $100,000,000.

These conditions have militated strongly against Britain's full recovery of her pre-war position and have prevented the establishment of an equilibrium of exchange at the place where it is most vital to the well-being of the world's commerce. Financiers in Britain realized at an early date the necessity of extending all possible credit and other assistance to Europe. To accomplish this end they have stood as intermediaries between the United States and continental borrowers and have assumed on this semi-altruistic basis a vast responsibility that has played a predominant part in delaying the return of sterling to a more normal rate of exchange.

3. *Reasons for disorganization.*—There are four clearly defined reasons for the disorganization of foreign exchange. Briefly stated they are: 1. The war period of one sided business; 2. The existence of paper currencies unsupported by adequate gold reserves; 3. Loss of means of production; 4. Disorganization of working forces.

A full consideration of the relations of these reasons to one another, and the extent to which any one may be directly or indirectly responsible for the existence of another would lead us into the realm of economics, rather than that of exchange. We shall, therefore, consider each of the reasons in its effect upon international exchange only.

4. *Spending more than national income.*—No business, whether individual or national, can continue to buy indefinitely while making no profit producing sales. To do so means bankruptcy. Yet during the years of the war the belligerent nations of Europe

were forced to follow this course at breakneck speed. The result was to use up what may be termed their quick assets in varying degrees that range all the way from the seemingly complete bankruptcy of Austria to the uncomfortably reduced status of affairs in France. They were forced to buy, largely from America, the food and clothing for their people and the munitions and stores for the prosecution of the war; yet they were able during those years to throw into the currents of world trade practically nothing with which to create credits to meet their debts. Nations, like corporations, must go thru a refunding process when they have verged upon bankruptcy, and this process is still in progress.

This excess of expenditure over income meant the exhaustion of raw material and the necessity of negotiating the purchase of more at longer terms of credit than the existing machinery of exchange made any provision for. The resultant breakdown of exchange between nations has been partially the result of this *impasse;* debts, no raw materials with which to produce the means of paying them, few long credits to make raw material available.

5. *Inflation.*—The effect upon foreign exchange of paper currencies unsupported by adequate gold reserves (or of inflation as it is usually called) is one of the most important features of the reconstruction period.

Unsupported currency is a monetary invention with highly explosive properties. Conscientiously and carefully handled, it may be an effective means of tiding over an emergency, but under the control of an unscrupulous or careless government it may lead to ruin and disaster. Russia to-day presents an example of criminal use of inflated currency, in fact the currency inflation in that country has simply run wild. Germany, Austria, Hungary, Jugo-Slavia and Czecho-Slovakia have all been thru the slough of unwise issue and administration of paper money and are only now beginning to reap the results of the application of sound principles to their monetary situations.

Professor Jevons said many years ago regarding paper money:

> The issue of an inconvertible money has often been recommended as a convenient means of making a forced loan from the people, when the finances of the government are in a desperate condition. It is true that money may be thus abstracted from the people, and the government debts are effectually lessened. At the same time however, every private debtor is enabled to take a forced contribution from his creditor. A government should, indeed, be in a desperate position, which ventures thus to break all social contracts and relations which it was created to preserve.[1]

Many governments were in desperate positions at times during the war, and there is no doubt that practically all of them became victims of the paper money lure to a greater or less degree.

An unfortunate feature of currency inflation is that the commercial life of a nation absorbs the excess money as a sponge soaks up water. Behind the hysterically good times that are its first symptoms few recognize the disease that will later produce social unrest, and if not checked in time, financial panic. The paper money once involved in the credit structure of a country must be squeezed out slowly if a general crash is to be avoided. There is, then, every prospect of inconvertible paper money existing in a number of countries for a considerable time. The result of this must be instability of exchange rates.

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[1] "Money and Mechanism of Exchange," W. S. Jevons, D. Appleton, New York, 1882.

There is a discouraging element of uncertainty in all business transacted with countries on a paper basis. No man is sure of what he is going to get in return for goods shipped into such a country. Normally, under the gold standard, he knew he was going to get gold or its equivalent, transferable at fairly definite rates to any other country with which he was doing business. Today there is no such assurance. With the payment received for goods he has shipped in he may purchase goods for export from the country, or acquire other property. The transfer to another country of his funds in the form of a credit can be made only at a rate of exchange that reflects all the uncertainty of the paper currency, which during the life of even a short term bill of exchange may suffer a change in value in comparison with the gold standards that all of the nations are maintaining in theory and in hope of recuperation.

6. *Loss of means of production.*—For the purposes of our present consideration the loss of means of pro-

duction may be considered in a widely inclusive sense. If we return for a moment to Dean Johnson's statement of the United States in account with the world, we shall see that merchandise overshadows in value all other elements that compose the vast total which must be cleared annually by exchange transactions. What is here shown for the United States would be clearly shown in a summarized account for any of the commercial nations. The important bearing of the destruction and wearing out of means of production upon exchange becomes apparent. There were no depreciation funds or insurance policies to protect against the wanton ravages of war. Available capital was transformed as rapidly as possible into consumable goods and the necessary upkeep of production facilities was largely neglected.

7. *Disorganization of working forces.*—To treat fully the labor movement during the reconstruction period as it affects the exchange situation would lead us off into economics, politics and sociology. We must therefore be content with little more than a reference to it. The human element in industry needs no emphasis, and it is clear that casualties by the million, as suffered by France and Great Britain, disrupted all the old organizations. Moreover the men taken from industrial life who spent from three to five years in the various armies found it extremely difficult to adjust life and thought to peace conditions until after the lapse of months or even years. Men who remained in industry found governments and

government contract holders ready to pay fabulous wages to secure emergency production. Politics, nearly everywhere, crept into industry with the usual effect of too close association of such activities with any kind of business, the creation of false conditions. Moreover every industry in Europe was brought under government control. The ordinary conditions of production and sale were entirely superseded.

To return to peace time production standards and methods has meant reorganization of all the working forces. It is taking time to eradicate the false ideas of the value of labor and products that developed during the war, and the social, political and industrial unrest that attend the process have all delayed the return of exchange and international finance to a normal condition.

8. *Commercial parity.*—Definite assurance regarding value to be received has always characterized international business between actual gold standard countries. From the facts brought forth in our discussion of paper currencies it became apparent that such assurance has been reduced to a minimum, if not altogether destroyed. There is no doubt that it will remain so reduced as long as unsupported paper currencies exist in material quantities. As long as this condition persists it will be wise to consider exchange rates to be based to a very considerable extent upon commercial parity.

Commercial parity is based upon the actual purchasing power of the current domestic medium of exchange of a country. Valuation of a foreign money must therefore depend in part upon the relative purchasing powers of the currencies in both countries under consideration. This purchasing power will, in general, be in inverse proportion to the amount of inflation that has taken place.

Gustav Cassel of Stockholm, Sweden, goes so far as to set forth the following rule: "When two currencies have been inflated the new normal rate of exchange will be equal to the old rate multiplied by the quotient of the degrees of inflation in those countries." This signifies that if the rates of inflation in two countries are respectively 320 to 100 and 240 to 100, the new rate of exchange will be ¾ of the old rate. Two serious objections to the acceptance of this rule are that rates of depreciation are notoriously hard to determine, and purchasing power per unit can never be definitely known until after the event.

We have seen that payments received in any country operating with a paper currency must in most cases be converted into goods to permit their withdrawal without serious loss. It follows, therefore, that the amount of goods obtainable per unit must play a predominant part in fixing the international value of that unit. Thus in a country where prices are falling the value of its currency should appreciate in terms of the currencies of countries where prices are going up, or are falling less rapidly.

Without accepting in full the theory as set forth by Professor Cassel, it may be granted that the facts back of it will exert a strong influence upon exchange rates for some time to come. Index numbers based upon the cost of commodities take on new importance when considered in this connection. Even tho they are always the records of past performances, they will, when reduced to a common basis, show by comparison future tendencies of the exchange rates.

9. *The sensitive condition of exchange.*—During 1920 there were many events that showed an influence on exchange rates out of all proportion to their normal effects. Wars and rumors of wars drove quotations up and down, and almost every conference of the Allied Premiers or of the Supreme Council of the Allied Nations gave rise to new reports of dissolving or solidifying international friendships, and to rumors of new agreements regarding the fixing of the amounts and the terms of payment of the indemnities by the central powers. Careful study of the exchange rates quoted each day as these bits of news and gossip became public, shows how quickly they demonstrated the favorable or unfavorable opinion of the world of business.

The great strike and the subsequent change of methods of management in the Italian metal industries gave impetus to the slump of Italian exchange. The coal strike in Great Britain by its first serious threatenings drove sterling down several cents on the pound but caused, within a very short time, a decided movement of the rate in favor of Great Britain. The uncertainty of what the final adjustment of the wages of the coal miners would be on the first of January, 1921, continued to react against sterling quotations in New York right up to the end of 1920. These instances merely exemplify influences that have been operating to keep the exchange quotations fluctuating with a frequency never before experienced during the great industrial era of the nineteenth and twentieth centuries.

10. *Financial reconstruction and its effects.*—The beginning of the financial reconstruction process was marked by urgent calls for loans by the distressed countries. It was confidently expected that very large credits could be arranged quickly and easily in New York. As we have noted, this expectation was not fulfilled. Loans were floated, it is true, both in London and New York but they were small in comparison to the needs. Belgium, for example, had secured before the middle of 1920 about £13,000,000 in London, over two-thirds of which came from the British government, the remainder being subscribed by a syndicate of London bankers. From New York a similar syndicate provided $50,000,000 but these large sums failed to give more than a temporary improvement to the exchange rate.

All the countries that secured loans indulged in an illusory hope that their rates of exchange would be quickly restored to par. The exhaustion of these new credits showed the futility of such hope, for the rates at once went from bad to worse. The demands of all continental Europe were too great for the lending countries to meet. The needs of one country might have been fully satisfied but the urgent cries of a dozen produced a loss of confidence.

The whole European continent was prey to the one disease, differing only in intensity and curability. The same well known causes of depreciation were to be found everywhere. The balance of exports and imports was completely upset. Imports had to be made, yet there were few exports. Foodstuffs, machinery and raw materials were, in the circumstances, inelastic demands that had to be satisfied and payment made at high prices. Every country was exhausting its stock of investment securities salable in more fortunate lands. All such resources available for conversion into foreign exchange have been continually diminishing in proportion to the volume of business to be cleared, and the inevitable consequence has been a continual tho spasmodic rise in the exchange rates against such countries.

11. *Exportation of capital.*—The sale of securities reached such a volume that many of the European governments decided upon the choice of what they considered the lesser evil, namely, a further fall in their rates of exchange as quoted in New York and London. France had taken the lead in restricting such international movements of capital by the establishment of the Paris Exchange Commission in July, 1917. Other countries followed her example, altho the success of the scheme cannot be given higher praise than to say that it has served to retard the up-

ward flight of rates. Again using Belgium as an example we shall quote from Professor Maurice Ansiaux a description of the measures taken to restrict the movement of capital from that country.

> By order in Council of March 28th, 1919, the exportation of funds, securities, and coupons was consequently prohibited, as well also the sale of securities in Belgium for foreign account, unless the proceeds were reinvested in Belgian securities, or the securities themselves had been imported before the war. The Decree also set up an Exchange Committee, in which the non-official element (bankers, manufacturers, and merchants) was predominant, but at the same time including representatives of the different public departments concerned. Its function was two-fold. It was to apply to the needs of economic reconstruction such foreign credits as had been placed at the disposal of the Government. For this purpose it examined the requests for exchange which were submitted to it, and rejected those which did not appear to be connected with the work of reconstruction, thereby relegating them to the free market. In the second place the Committee was called upon to give its opinion about the special permissions given for the export of capital (securities, coupons, banknotes, or coin), which the Government had reserved to itself the right to grant in exceptional circumstances.
>
> The Exchange Committee exercised its functions regularly for several months. But, later on, its activity was gradually diminished until at last, in the course of the summer of 1919, it quietly expired. Until the end of the year the market was left entirely to itself. During that time rates were rising, and towards the end of January they started violently upwards. Industry and commerce were complaining of the increasing costliness of imported raw materials; the cost of living was rising higher and higher, provoking strike after strike in the public

services. The expenses of provisioning the country were becoming daily a more onerous charge upon the public purse.

This was the moment at which the Government judged it necessary to intervene energetically. On January 30th a decree was published establishing a strict control over exchange operations. All traffic in bills and currencies was forbidden, except such as was occasioned by genuine commercial transactions. Bankers, exchange brokers, and all other persons operating in foreign exchange were required to keep a register in which all transactions involving exchange were to be recorded, including sales of Belgian francs abroad. Heavy penalties were provided for breaches of these regulations. Finally, the Exchange Committee was superseded by a Commission consisting of four members nominated by the Government and two members nominated by the National Bank. The majority on this new body, therefore, no longer belongs to the business world, but applies itself in a far more rigorous and systematic spirit to the administration of the regulations, which themselves have been made more strict. The reason for this is that in the more serious conditions of today the most energetic measures are required[1]:

Belgium's action in this connection is typical of what has been done in many of the European countries, and reflects the unceasing and strenuous efforts of the nations to get back to a stable and self supporting economic and financial basis. It is, however, interesting to note that in February, 1921, the Belgium government gave up this effort to control artificially the market for securities and decided that it was the part of wisdom to let matters take their course.

12. *Efforts for concerted action.*—Early in 1920

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[1] "Belgian Exchange Since the War." The Economic Journal, London, Eng., June, 1920.

the Supreme Council of the Allied Nations realized the necessity for some concerted action on the financial status of the various countries, and called a small group of the most prominent financiers of Europe to advise on the best means to secure it. The result of their advice was the summoning of an international monetary conference which met at Brussels in 1920. The task set before this body was to secure as complete a presentation as possible of the economic and financial situation of the world, and by an interchange of opinion and experience to assist each country to arrive at the soundest policy possible for dealing with its existing difficulties. Some account of this conference is given in the Appendix.

13. *International and national issues.*—International gatherings such as that held in Brussels are very useful in clearing the atmosphere and bringing out the fact that many countries are suffering the same troubles. If they, however, encourage the nations to postpone reform pending international deliberation or even to expect that international action will be the chief agency in bringing them back to solvency, their influence is less beneficial. Without discounting the aid which one nation can render to another it is fair to say that nations which rely exclusively upon an international doctor or an international nurse to coax them back to health can count on remaining sick for a long time.

Recent years have brought out more strongly than ever before the existence of international obligations.

It is, however, to be feared that the continued insistence upon them will lead to a reaction. In the emergency of a world crisis such international obligations have a compelling force, but it is the essence of an emergency to be temporary. The feeling grows daily that the time must come soon when nations must stand upon their own feet. Just at the present time there is undoubtedly more prospect of a speedy restoration of normal conditions thru a calm survey of what each nation can do for itself and a firm resolution to do it than in a concert of nations which may restore harmony in economic affairs.

14. *National duty.*—It is the duty of every nation to put its own house in order. In many cases the task is a hard one but it is to be remembered that there is no easy road to affluence and well-being. Nations that have arrived at a position of economic prestige in the world's affairs in times past have done it thru the homely virtues of working and saving. Nothing else will achieve a similar result today. In the stress and strain of war, expedients were a necessity but they cannot be kept up indefinitely. Every year it becomes more and more difficult to adjust international payments on the basis of credits. The United States and other countries that are in a favorable position to lend capital to the world must have the promise of a definite return from such loans. The difficulties of the situation are very great both for the creditor and for the debtor nations.

15. *Difficulties in extending credit.*—It is urged

sometimes frantically that more than it has ever done in the past the United States must lend its credit to the other nations. It is speciously pointed out that only thru such loans of capital and credit in times past did Great Britain gain its financial ascendency and we are told that only by following in the same path can the United States retain its place as the world's banker and as a creditor nation.

It is undoubtedly true that the financial interests of the United States have until recently confined their attention largely to home investments. They have been under no necessity of looking abroad for the employment of capital. It is also true and not to be gainsaid that the interest in foreign investments will not grow materially until the time comes that they yield a greater profit than those at home. American financiers are no less keen to make a profit than are their British brethren. In like conditions they will act in the same way, loaning money, or rather capital, freely.

There is not a complete parallel between the position of the United States today and that of Great Britain before the war. An analysis of foreign investments, that is, credits to debtor nations, will show that for the most part that they have been made for the purpose of supplying fixed capital for the industrial development of the debtor nation. They have been used sparingly for the purpose of supplying such nations with working capital and not at all for the purpose of allowing the debtor nation to purchase consumable goods.

Now the need of Europe today is in the first instance for food and clothing, in the second instance for raw materials and in the third for fixed capital. The problem is to keep the people alive and to get them to work rather than to increase the facilities for the production. American philanthropy has not been deaf to the cry of starving millions in Europe but it is obvious that widespread destitution is not a basis for business investment. Nor is it a simple matter to provide for European producers the raw material necessary for the resumption of industry. Some operations of this character are contemplated by corporations organized under the Edge Act, but they represent a comparatively novel form of international finance, and a rapid development is hardly to be expected.

Thus it will be seen that there is far from being an exact parallel between the loans which Great Britain has made in times past for the development of rich, tho backward, countries, and the further extension of credit by the United States to the stricken peoples of Europe. The mere following of British methods will not meet the situation. New and more complex credit forms must be developed and the process cannot be hurried.

16. *Need of increased production.*—These considerations indicate that in the countries suffering from a low rate of exchange with the United States

the solution of the exchange question lies in increased production rather than in fiscal manipulations. The sooner they realize this as nations and as individuals and the more they bend their backs to bear the burdens which war has imposed, the sooner may they hope that their international economic relations will return to a sane and normal basis.

It is one of the encouraging signs of the times that with greater or less energy and with greater or less intelligence the nations are working towards the restoration of the former conditions. They look forward to the day when the old par of exchange will be restored and the fetters that shackle their trade be broken. It is to their interest and to the interest of civilization as a whole that such a result be speedily obtained.

REVIEW

Outline briefly the four reasons for the disorganization of international exchange.

Define the word *inflation* as applied to currencies.

Why is inconvertible paper money a usual result of war?

What are the effects of currency inflation on the exchange rates of a country?

Define commercial parity. Why has it become of great importance in connection with foreign exchange?

Describe the difficulties which the United States encounters in extending credit to Europe in the present juncture.

NOTE: Numerous questions of business practice and procedure are discussed in detail in the Modern Business Reports. The current list contains the following Reports which in their subject matter are more or less related to questions arising in a consideration of International Exchange:

4, Investment Trusts;
93, Organizing Export Combinations Under the Webb Act.

APPENDIX A

THE BRUSSELS CONFERENCE

Representatives of thirty-nine nations assembled for the conference and because of the volume of evidence and opinion to be recorded, and the different phases of the situation to be considered, divided the work among commissions composed of the best qualified experts along each particular line. These commissions reported in the form of resolutions which were adopted by the conference.

Many of the resolutions are rather axiomatic in character, tho it must be admitted that their reiteration in this way called salutory attention to the fact that they were being disregarded to a greater or less degree by many peoples and governments.

The conference crushed ruthlessly any false hopes there may have been of possibilities of recovery without hardships and sacrifices. Emphasis was placed upon the fact that industry must be so organized as to encourage maximum production, as only by production and still more production can international credit relations be rehabilitated.

The resolutions proposed by the Commission on Currency and Exchange and that upon International Credit display the closest relationship to the subject of exchange. We shall therefore give them verbatim.

Resolutions on Currency and Exchange

The currency of a country, in the sense of the immediate purchasing power of the community, includes (*a*) the actual legal tender money in existence, and (*b*) any promises to pay legal tender, *e.g.*, as Bank balances—which are available for ordinary daily transactions.

The currencies of all belligerent and of many other countries, though in greatly varying degrees, have since the beginning of the war been expanded artificially, regardless of the usual restraints upon such expansion (to which we refer later) and without any corresponding increase in the real wealth upon which their purchasing power was based; indeed in most cases in spite of a serious reduction in such wealth.

It should be clearly understood that this artificial and unrestrained expansion, or "inflation" as it is called, of the currency or of the titles to immediate purchasing power, does not and cannot add to the total real purchasing power in existence, so that its effect must be to reduce the purchasing power of each unit of the currency. It is, in fact, a form of debasing the currency.

The effect of it has been to intensify, in terms of the *inflated* currencies, the general rise in prices, so that a greater amount of such currency is needed to procure the accustomed supply of goods and services. Where this additional currency was procured by further "inflation" (*i.e.*, by printing more paper money or creating fresh credit) there arose what has been called a "vicious spiral" of constantly rising prices and wages and constantly increasing inflation, with the resulting disorganization of all business, dislocation of the exchanges, a progressive increase in the cost of living, and consequent labor unrest.

Therefore:

I. *It is of the utmost importance that the growth of inflation should be stopped*, and this, altho no doubt very difficult to do immediately in some countries, could quickly be accomplished by (1) abstaining from increasing the currency (in its broadest sense as defined above), and (2) by increasing the real wealth upon which such currency is based.

The cessation of increase in the currency should not be achieved merely by restricting the issue of legal tender. Such a step, if unaccompanied by other measures, would be apt to aggravate the situation by causing a monetary crisis. It is necessary to attack the causes which lead to the necessity for the additional currency.

The chief cause in most countries is that the Governments, finding themselves unable to meet their expenditures out of revenue, have been tempted to resort to the artificial creation of fresh purchasing power, either by the direct issue of additional legal tender money, or more frequently by obtaining—especially from the Banks of Issue, which in some cases are unable and in others unwilling to refuse them—credits which must themselves be satisfied in legal tender money. We say, therefore, that—

II. *Governments must limit their expenditure to their revenue. (We are not considering here the finance of reconstructing devastated areas.)*

III. *Banks, and especially Banks of Issue, should be freed from political pressure and should be conducted solely on the lines of prudent finance.*

But the Governments are not the only offenders in this respect; other parties, and especially in some countries the municipalities and other local authorities, have raised excessive credits which in the same way multiply the titles to purchasing power.

Nor will it be sufficient, for the purpose of checking further inflation, that additional issues of legal tender or the granting of additional credits should cease; since the floating debts of Government and other authorities constitute in themselves a form of potential currency, in that, except in so far as they are constantly renewed, their amount will come to swell the total currency in existence; consequently—

IV. *The creation of additional credit should cease and*

Governments and municipalities should not only not increase their floating debts, but should begin to repay or fund them by degrees.

In normal times the natural and most effective regulator of the volume and distribution of credit is the rate of interest which the central Banks of Issue are compelled, in self-preservation and in duty to the community, to raise when credit is unduly expanding. It is true that high money rates would be expensive to Governments which have large floating debts, but we see no reason why the community in its collective capacity (*i.e.*, the Government) should be less subject to the normal measure of restricting credit than the individual members of the community. In some countries, however, the financial machinery has become so abnormal that it may be difficult for such corrective measures to be immediately applied. We recommend, therefore, that—

V. *Until credit can be controlled merely by the normal influence of the rate of interest, it should only be granted for real economic needs.*

It is impossible to lay down any rule as to the "proper rates" of discount or interest for different countries. These rates will depend not only on the supply and demand at different times but also on other factors often of a psychological nature. It may, indeed, confidently be said that when once the arbitrary increase of inflation ceases and when the Banks of Issue are able successfully to perform their normal functions, rates will find their own proper level.

The complementary steps for arresting the increase of inflation by increasing the wealth on which the currency is based, may be summed up in the words: increased production and decreased consumption.

The most intensive production possible is required in order to make good the waste of war and arrest inflation, and thus to reduce the cost of living; yet we are witnessing in many countries production below the normal, together with those frequent strikes which aggravate instead of help to cure the present shortage and dearness of commodities. When diminution in the Government's demands frees more credits for trade and for the recuperation of the world, when inflation has ceased and prices cease to rise, and when the general unsettlement caused by the war subsides, it is probable that great improvement will be seen in productive activity. Yet, in our opinion, the production of wealth is in many countries suffering from a cause which it is more directly in the power of Governments to remove, viz, the control in various forms which was often imposed by them as a war measure and has not yet been completely relaxed. In some cases, business has even been taken by Governments out of the hands of the private trader, whose enterprise and experience are a far more potent instrument for the recuperation of the country.

Another urgent need is the freest possible international exchange of commodities. With this another Commission will deal, but we feel that our recommendations here on inflation would not be complete without adding that—

VI. *Commerce should as soon as possible be freed from control, and impediments to international trade removed.*

Equally urgent is the necessity for decreased consumption in an impoverished world where so much has been destroyed and where productive power has been impaired. It is, therefore, specially important at present that, both on public and private account, and not only in impoverished countries, but in every part of the world—

VII. *All superfluous expenditures should be avoided.*

To attain this end, the enlightenment of public opinion is the most powerful lever. If the wise control of credit brings dear money, this result will in itself help to promote economy.

We pass now from inflation and its remedies to the other points submitted to us.

Without entering into the question whether gold is or is not the ideal common standard of value, we consider it most important that the world should have some common standard, and that, as gold is today the nominal standard of the civilized world—

VIII. *It is highly desirable that the countries which have lapsed from an effective gold standard should return thereto.*

It is impossible to say how or when all the older countries would be able to return to their former measure of effective gold standard, or how long it would take the newly formed countries to establish such a standard. But in our opinion—

IX. *It is useless to attempt to fix the ratio of existing fiduciary currencies to their nominal gold value;* as, unless the condition of the country concerned were sufficiently favorable to make the fixing of such ratio unnecessary, it could not be maintained.

The reversion to, or establishment of, an effective gold standard would in many cases demand enormous deflation and it is certain that such—

X. *Deflation, if and when undertaken, must be carried out gradually and with great caution;* otherwise the disturbance to trade and credit might prove disastrous.

XI. *We cannot recommend any attempt to stabilize the value of gold and we gravely doubt whether such attempt could succeed;* but this question might well be submitted to the Committee to which we refer later, if it should be appointed.

XII. *We believe that neither an International Currency nor an International Unit of Account would serve any useful purpose* or remove any of the difficulties from which International Exchange suffers today.

XIII. *We can find no justification for supporting the idea that foreign holders of Bank notes or Bank balances should be treated differently from native holders.*

XIV. *In countries where there is no central Bank of Issue, one should be established,* and if the assistance of foreign capital were required for the promotion of such a Bank, some form of international control might be required.

XV. *Attempts to limit fluctuations in Exchange by imposing artificial control on Exchange operations are futile and mischievous.* In so far as they are effective they falsify the market, tend to remove natural correctives to such fluctuations and interfere with free dealings in forward Exchange which are so necessary to enable traders to eliminate from their calculations a margin to cover risk of exchange, which would otherwise contribute to the rise in prices. Moreover, all Government interference with trade, including Exchange, tends to impede that improvement of the economic conditions of a country by which alone a healthy and stable exchange can be secured.

We support the suggestion that—

XVI. *A Committee should be set up* both for continuing the collection of the valuable financial statistics that have been furnished for this Conference and also the further investigation of currency policy.

RESOLUTIONS ON INTERNATIONAL CREDIT.

I. The Conference recognizes in the first place that the difficulties which at present lie in the way of international credit operations arise almost exclusively out of the disturbance caused by the war, and that the normal working of financial markets cannot be completely re-established unless peaceful relations are restored between all peoples and the outstanding financial questions resulting from the war are made the subject of a definite settlement which is put into execution.

II. The Conference is, moreover, of opinion that the revival of credit requires as primary conditions the restoration of order in public finance, the cessation of inflation, the purging of currencies, and the freedom of commercial transactions. The resolutions of the Commission on International Credits are therefore based on the resolutions of the other Commissions.

III. The Conference recognizes, however, that this general improvement in the situation requires a considerable period of time, and that in present circumstances it is not possible for certain countries to restore their economic activity without assistance from abroad. This assistance is required for periods which exceed the normal term of commercial operations.

IV. The Conference is of opinion that in principle the resources out of which this assistance is to be provided should be found from the savings of the lending countries and must not result in undue increase of the fiduciary circulation—that is to say, in the creation or extension of a disproportion between means of payment and the genuine requirements of business.

V. The Conference believes, on the other hand, that this assistance can only be effectively accorded to countries which are prepared to assist one another in the restoration of economic life, and to make every effort to bring about within their own frontiers the sincere collaboration of all groups of citizens and to secure conditions which give to work and thrift liberty to produce their full results.

VI. The Conference does not believe that, apart from particular decisions dictated by national interests or by considerations of humanity, credits should be accorded directly by Governments.

VII. It appears to the Conference that one of the chief obstacles to the granting of credits is the absence in borrowing countries of sufficient security for ultimate repayment. The Conference therefore studied with attention in the light of the general considerations enumerated above all the proposals presented with a view to creating guarantees which would provide satisfactory security for exporters.

The Conference has been forced to recognize that no single system could by itself suffice to provide for the many different needs of the various countries, and that it is necessary to indicate a series of measures sufficiently elastic to be adapted afterwards to every variety of circumstances.

For these reasons the Conference decided to make the following recommendations:

VIII. An international organization should be formed and placed at the disposal of States desiring to have resort to credit for the purpose of paying for their essential imports. These States would then specify the assets which they are prepared to pledge as security for the sake of obtaining credit, and would come to an understanding with the international organization as to the conditions under which these assets would be administered.

The bonds issued against this guarantee would be used as collateral for credit intended to cover the cost of commodities.

A plan based upon these principles is developed in the Annex. It has been devised to enable States to facilitate the obtaining of commercial credits by their nationals. It is easy to see that the scheme is susceptible of development in various directions, and that some of its provisions might be adapted so as to facilitate the extension of credit direct to public corporations.

A Committee of financiers and business men should be nominated forthwith by the Council of the League of Nations for the purpose of defining the measures necessary to give practical effect to this proposal.

IX. It has been represented to the Conference that more complete results might be achieved if the bonds used as collateral were to carry some international guarantee.

The Conference sees no objection to the further consideration of this proposal. The Committee referred to in paragraph VIII above might usefully consider the conditions under which it could be applied.

X. It has also been represented to the Conference that an extension on international lines of the existing system of export credit insurance would in many instances be of great value in developing trade with countries where political and social conditions give rise to an anxiety which is often exaggerated by exporters. The Conference believes that an extension of this kind is worthy of consideration, and that it should be examined in detail by experts.

XI. The attention of the Conference has been called to the present system of "finishing credits," that is to say, of credits under which a lien in favor of the exporter or a banker is maintained on the raw material in all its different stages and upon the proceeds of the manufactured article. This system has suffered greatly owing to the lack, in many countries, of sufficient legal protection for the exporter thruout the various stages of importation, manufacture, re-exportation and sale. The Conference would suggest that the Council be recommended to draw the attention of the different Governments to this question, and to summon an advisory body of legal experts and business men to specify the legislative action it would be desirable to take in order to attain the desired object in each of the countries concerned.

XII. Apart from the above-mentioned proposals which the Conference recommends the League of Nations to adopt, and if possible to apply in practice, the Conference believes that the activities of the League might usefully be directed towards promoting certain reforms, and collecting the relevant information required to facilitate credit operations. In this connection the Conference considers it well to draw attention to the advantages of making progress under each of the following heads:

(1) Unification of the laws relating to bills of exchange and bills of lading;

(2) The reciprocal treatment of the branches of foreign banks in different countries;

(3) The publication of financial information in a clear, comparative form;

(4) The examination of claims by the holders of bonds the interest on which is in arrear;

(5) An international understanding on the subject of lost, stolen or destroyed securities;

(6) The establishment of an international clearing house;

(7) An international understanding which, while ensuring the due payment by everyone of his full share of taxation, would avoid the imposition of double taxation which is at present an obstacle to the placing of investments abroad.

XIII. During the course of its deliberations the Conference could not fail to be impressed by the fact that all, or almost all, of the many proposals submitted for its consideration require at some stage the active intervention of the League of Nations. The Conference is unanimously in sympathy with this tendency, and believes that it is desirable to extend to the problems of finance that international cooperation which the League of Nations has inaugurated, and which it is attempting to promote in order to improve the general situation and maintain the peace of the world.

DETAILS REGARDING BOND ISSUE.

1. In order that impoverished nations, which under present circumstances are unable to obtain accommodation on reasonable terms in the open market, may be able to command the confidence necessary to attract funds for the financing of their essential imports, an international commission shall be constituted under the auspices of the League of Nations.

2. The commission shall consist of bankers and business men of international repute, appointed by the Council of the League of Nations.

3. The commission shall have the power to appoint sub-commissions and to devolve upon them the exercise of its authority in participating countries or in groups of participating countries.

4. The Governments of countries desiring to participate shall notify the commission what specific assets they are prepared to assign as security for commercial credits to be granted by the nationals of exporting countries.

5. The commission, after examination of these assets,

shall of its own authority determine the gold value of the credits which it would approve against the security of these assets.

6. The participating Government shall then be authorized to prepare bonds to the gold value approved by the commission, each in one specific currency to be determined on the issue of the bond.

7. The date of maturity and the rate of interest to be borne by these bonds shall be determined by the participating Government in agreement with the commission.

8. The service of these bonds shall be secured out of the revenue of the assigned assets.

9. The assigned assets shall in the first instance be administered by the participating Government or by the international commission as that commission may in each case determine.

10. The commission shall at any time have the right of making direct representations to the Council of the League of Nations as to desirability of transferring the administration of the assigned assets either from the commission to the participating Government or from the participating Government to the commission.

11. The decision of the Council of the League of Nations on this question shall be binding.

12. After the preparation of these bonds the participating Government shall have the right to loan the bonds to its own nationals, for use by them as collateral security for importations.

13. The bonds shall be made out in such currencies and in such denominations as are applicable to the particular transaction in respect of which they are issued.

14. The participating Government shall be free to take or not to take security for the loan of these bonds from the nationals to whom they are lent.

15. The maturity and the rate of interest of the loan of the bonds shall be fixed by agreement between the participating Government and the borrower of the bonds; they

need not be the same as the maturity and the rate of interest of the bonds themselves.

16. When making application to his Government for a loan on these bonds, the importer must furnish proof that he has previously obtained from international commission express permission to enter into the transaction for which the bonds are to be given as collateral.

17. Each bond, before it is handed over by the participating Government to the importer, shall be countersigned by the commission in proof of registration.

18. Having obtained the consent of the commission and received from them the countersigned bonds, the importer will pledge these bonds to the exporter in a foreign country for the period of the transaction.

19. The exporter will return to him on their due dates the coupons of the pledged bonds, and the bonds themselves on the completion of the transaction.

20. On receipt of the coupons and the bonds respectively, the importer will return them to his Government.

21. Bonds returned to the participating Government shall be cancelled and may subsequently be replaced by other bonds, either in the same or in a different currency, up to an equivalent amount.

22. The exporter, or if he has pledged the bonds the institution with which he has repledged them acting on his behalf, would be free, in the event of the importer not fulfilling the terms of his contract, to hold until maturity the bonds given as collateral by the importer, or to sell them in accordance with the custom in his country in case of default.

23. In the second alternative an option of repurchasing the bonds direct must first be given for a short period to the Government which issued them.

24. If a sale is resorted to and results in a surplus beyond what is necessary to cover the claims of the exporter upon the importer, the exporter shall be held accountable for that surplus to the Government which issues the bonds.

25. The revenues from the assigned assets shall be applied as follows to the service of the bonds.

26. Out of these revenues, the commission or the participating Government, as the case may be, shall purchase foreign currencies sufficient to meet at their due date the coupons on all bonds any time outstanding in the different foreign currencies.

27. In addition they shall establish abroad in the appropriate currencies a sinking fund calculated to redeem at maturity 10 per cent of the bonds outstanding in each of the different countries.

28. Further, in addition to the amounts provided for payment of coupons and for the endowment of the sinking fund, they shall establish out of the assigned revenues a special reserve in one or more foreign currencies for the redemption of bonds sold in accordance with par. 22.

29. The amount to be set aside for the special reserve shall in each case be determined by the commission.

30. Any surplus remaining at the end of each year after the provision of these services shall be at the free disposal of the participating Government.

31. A participating Government shall have the right to offer its own bonds as collateral for credits obtained for the purpose of importations on Government account. The previous assent of the commission will in these cases also be required for the particular importations desired by the participating Government.

32. If a participating Government which has been in control of its assigned revenues should fail to fulfil its obligations, the exporter concerned will notify the commission and the commission will apply to the Council of the League of Nations for the transfer of the management of the assigned revenues to the commission.

33. The consent of the commission is necessary whenever bonds secured on the assigned assets are given as collateral and shall as a rule be accorded only for the import of raw materials and primary necessities.

34. The commission may, however, at its discretion,

sanction in advance the importation of specified quantities of such goods.

35. Even in the case of imports under such a general sanction a notification of the particular transaction must be registered with the commission.

36. The assent of the commission must also be obtained in every case to the term of the credit which it is proposed to open.

APPENDIX B

DOMESTIC EXCHANGE

Before the development of the Federal Reserve System, the business men of the United States were familiar with domestic exchange which expressed itself in the form of premiums on New York drafts, collection charges for out-of-town checks and in other ways.

The situation which existed a few years ago is described by Dean Joseph French Johnson in his "Money and Currency," as follows:

> Payments between different communities of the same country may be effected by the shipment of currency or by the use of credit. In the United States some form of credit is usually employed, shipments of currency being made only when the people of a community as a result of their business transactions are called upon to make payments to outsiders in excess of the payments due to them. Every bank in the United States has funds on deposit in one or more banks in other communities, and thus is able to sell to its customers drafts calling for the payment of money in other cities. Every bank in the United States can sell a draft on New York or even on London. All country banks do not maintain deposit accounts in New York City, but have deposit accounts with banks in near-by large cities, and these have balances

in New York upon which their country correspondents[1] are permitted to draw.

For example, a bank in Barre, Massachusetts, need maintain no deposit account in New York in order to sell a draft on New York, a credit balance in some Boston bank being all that is necessary. When one of its customers desires a draft on New York the Barre bank may issue it to him upon a blank furnished by its Boston correspondent. The Barre bank immediately notifies the Boston bank of the transaction. The latter debits the Barre bank with the face of the draft, and advises its New York correspondent that such a draft has been drawn at Barre; and the New York bank, when it honors or pays the draft, debits its face to the Boston bank. In this simple way the banks of the country are all linked together. Small banks in the neighborhood of New Orleans, for example, sell exchange upon New York through their relations with the New Orleans banks. In the same way small banks in the neighborhood of St. Paul have power to sell exchange upon New York or upon Chicago through their relation with the banks of St. Paul. Thus the country is made up of small financial circles and centers, all included within a great circle of which New York is the grand center.

The medium most employed for the payment of debts between different communities is New York exchange. By this is meant a draft, or other credit instrument payable in New York City. The acceptability of New York exchange thruout the country is due primarily to the fact that New York is the commercial center of the country. Tradesmen everywhere have dealings with New

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[1] "Correspondent" is the technical term employed by banks to designate those banks with whom they maintain deposit accounts or for whom they carry deposits. Thus the First National of St. Louis and the Sixth National of New York may be correspondents, the St. Louis bank maintaining a deposit account in the New York bank. The New York bank has no need for a deposit balance in St. Louis, but makes use of the services of its St. Louis correspondent for the collection of checks upon banks in St. Louis or its neighborhood.

York City. There is not a store in the country which does not receive either directly or indirectly certain of its supplies from that city. The greater portion of the surplus products of the country each year passes thru the port of New York on its way to Europe. The manufacturers of New York are the largest customers of the producers of raw materials.

Thus it happens that every part of the country contains men who are selling goods to New York, and also men who are buying goods from there. If all payments were made with money, the one class would be receiving sums of money from New York while the other class would be shipping sums of money to New York. By the use of credit the shipment of money is almost entirely dispensed with. When a southern cotton factor, for example, ships cotton to New York he may receive payment in a check on a New York bank. This he deposits in his local bank, receiving credit therefor as if he had deposited money. On the other hand when a southern merchant receives goods from New York he buys from his local bank a draft on that city and with it satisfies the claim of his New York creditor. In neither case is the shipment of money or currency necessary.

How the local banks get their power to sell drafts on New York can best be shown by a concrete illustration. We will suppose that a bank in Aurora, Illinois, has on deposit $10,000 with the First National of Chicago. Let us suppose that an Aurora manufacturer has sold stoves to an eastern dealer and has received in payment a check for $1000 on the Corn Exchange bank of New York. He will deposit this check in his Aurora bank, which will send it to its Chicago correspondent, and thereby increase its credit balance to $11,000. The Chicago bank will send the check to its correspondent in New York, and so increase its credit balance in New York by $1000. By an arrangement with the First National of Chicago the Aurora bank is able to sell drafts on the Corn Exchange of New York, using for the purpose blank drafts furnished by the

First National. It is quite possible that on the same day a merchant in Aurora, who has bought goods from New York, will call upon the Aurora bank for a draft on New York. He may not want a draft for exactly $1000, but that does not matter. The Aurora bank is able to sell to him a draft for any amount up to $11,000, for its credit balance in the Chicago bank gives it a right to "draw" upon New York for that amount. Thus, on account of New York's trade relations with all parts of the country, banks everywhere are usually able to sell drafts on that city without being compelled to ship currency.

New York exchange is used not only for payments between New York and other parts of the country, but also for payments between points in the United States outside of New York. A man living in Buffalo who owes $1000 to a man in New Orleans can best pay the debt by remitting a draft on New York City. This method is the one usually employed, for Buffalo banks maintain no balances in New Orleans, and so cannot sell drafts on that city. They can, however, sell a draft on New York, and that will usually be accepted by New Orleans banks at par. When the reader takes into account that New York checks and drafts are every day being used in this way for the cancellation of debts in all parts of the United States, he will understand why New York exchange is deservedly called "the business man's money."

CAUSES OF CURRENCY SHIPMENTS.

But does not a bank sometimes receive a call for more New York exchange than it can conveniently sell? This does frequently happen, and as a result bankers are sometimes forced to charge a small premium for New York exchange. The price which they can charge is definitely fixed by the cost of shipping currency. This cost depends upon three items: first, the express charge; second, insurance; third, the loss of interest. As a rule, the first two charges are linked together in a charge made by the express company, on account of its guaranty to deliver the currency to the consignee. The third item of cost varies with the rate of interest. The moment a bank gives money to an express company for shipment to New York City, the bank's power to use it as a reserve, or basis for loans, has gone. That money cannot again become the basis for banking transactions until it has reached New York. The amount of this item is high or low according to the rate of interest at the point from which the shipment is made. These three items amount to about 50 cents per $1000 on a shipment of currency between New York City and Chicago. Hence Chicago bankers are not able to charge more than 50 cents premium on a New York draft for $1000. A man who wishes to send $1000 to New York will not pay a bank over $1000.50 for a draft, for at that price he can ship the currency by express.

The shipment of currency from one point to another and the fixing of the rate of exchange are matters attended to by the banks themselves. No private business man—excepting perhaps a few whose transactions foot up large totals—ever thinks of shipping currency from one point to another. If the people of a western city have been buying from the East more largely than they have sold to it, so that their calls upon the local banks for New York exchange exceed the incoming supply, the banks themselves are forced to ship currency to New York in order to cover their sales of exchange. In the large cities the banks make a business of buying and selling exchange from one another. When the First National of Chicago for example, finds that its New York balance is running low on account of the demand by its customers for New York drafts, it endeavors to buy exchange from other banks in Chicago, and will pay them a premium for it. In no case, however, will it pay more than 50 cents per $1000. The sellers will be banks which find that they have on hand more exchange on New York than they have need for, and they will ask for this exchange as high a premium under 50 cents per $1000 as they can obtain. The height of the premium is fixed by competition between buying and selling banks. Sometimes the supply of New York exchange will be so great that it will be sold by one bank to another at a discount. If a bank having a large credit in New York City orders currency shipped to it, the expense on each thousand dollars will be 50 cents. The bank can better afford to sell drafts on New York to its neighborhood at a discount of 40 cents per $1000 than order the shipment made.

In the long run the supply of New York exchange in any community is about equal to the demand for it. This is another way of saying that each community in the long run sells to other communities as much as it buys from them. In certain seasons of the year, however, agricultural districts buy much more from the East than they sell to it. This is always the case in the winter and spring. No crops are then being harvested, yet merchants all over the country are laying in their stock of spring and summer goods. As a result there is so strong a demand thruout the country for drafts on New York that country banks are generally obliged to make some shipment of currency to New York in order to cover the drafts they sell. The opposite condition prevails in the fall when the crops are marketed and are going forward for export. Then the farmers of the West and planters of the South are receiving in payment for their goods eastern checks, which they deposit in local banks. Country banks now find their balances piling up in New York and are unable to sell New York exchange as fast as they would like. As a result New York City banks are usually ordered in the fall to make shipments of cash to the West. In the winter and spring, when the West is a heavy buyer from the East, New York exchange is usually quoted at a premium in western cities. In the autumn it is usually at a discount, all banks having an excessive supply.

There is another reason for this seasonal movement of currency between New York and the country districts. In the autumn, when the crops are harvested, there is a great increase thruout the West and the South in the need for "hand-to-hand money." This must be furnished by the country banks, and they are forced to draw on their New York balances, first by sales of New York exchange and finally by ordering the cash shipped to them. In the winter and spring cash flows back into the country banks, until they have more than they can profitably use. Then they build up their New York balances either by buying and remitting exchange or by shipping currency.

What is to prevent a community from sometimes buying much more from New York than it sells to that city? Indeed, is not any community always in danger of purchasing so much from other parts of the country that its bankers may be obliged to send out all their supply of currency in order to make the payments? This brings up the question of the balance of trade between communities. The balance of trade is usually discussed by economists only in relation to trade between different countries yet the principles governing such trade differ in no respect from those governing trade between communities within the same country.

There is never any danger that a community will be stripped of its money or cash as a result of its purchase of goods from other communities. No matter how freely Chicago and the country tributary to it may purchase goods from the East, those purchases can never make any serious drain upon the cash supply of Chicago. No matter how extravagant the people of the West may be, their purchases of eastern goods can never be greatly in excess of their sales to eastern consumers. Should the people of Chicago for extraordinary reasons at any time increase their purchases from New York and other eastern cities, the first effect in Chicago would be an increase in the demand for New York exchange and in bank shipments of currency from Chicago to New York. The loss of currency in Chicago, since it would reduce the lending power of Chicago banks, would tend to cause a rise in the rate of interest and a rise in the value of money. The prices of commodities named would begin to decline; not of all commodities, but of those which are subjects of speculation, such as stocks, wheat, corn, and pork. Most of the speculators in these articles are borrowers, and the interest they pay is an important item in the expenses of their business, so that when the interest rate rises they are obliged to contract their operations. Chicago would thus become a good place to lend in and also a good place in which to buy stocks and bonds, wheat, and other speculative commodities. In other words, the value of money would rise in Chicago, and people in other parts of the country would increase their purchases in Chicago markets, remitting New York exchange in payment. The reader must not suppose that these changes in price or in the rate of interest need be so great as to attract general attention. Nevertheless it cannot be doubted that such changes do take place, and that as a result the sales of Chicago to other parts of the country are so adjusted that in the long run they furnish a supply of New York exchange equal to the demand.

Thus it happens thruout the country that in the course of a year the debts of every community are always practically balanced by its credits on account of sales, so that large shipments of currency are never necessary. Indeed, if our monetary banking systems were perfect, no shipment of currency from one part of the country to another would ever occur as a necessity result of trade transactions. Money or currency would only be shipped to a community as a result of an increasing need for it as a medium of exchange or as a basis for the expansion of bank credits. In Canada, for example, on account of the elasticity of its bank-note circulation, seasonal variations in the demand for currency are easily provided for by the local banks and their branches.

The tendency of commercial nations is to reduce premiums and discount upon domestic exchange to the minimum. This is effected in the first instance by the concentration of the business in the larger banks. The fewer the persons concerned the less the likelihood that any currency shipments will be required and hence the fundamental condition which causes payments at distant points to be more expensive than local payments disappears.

The demand for payments between communities is then a fluctuating one, now inclining in one direction, now in the other. If we conceive that all these transactions were effected thru a single bank with large capital and with branches in different places, adjustments could be made with the minimum difficulty. To the bank it would mean in the main a different drain on the resources of the different branches at different times which in the long run would equalize one another. Under these circumstances the bank, in order to facilitate to the utmost exchanges between all parts of the country, might very well agree to accept all payments at face value charging no premium therefor and allowing no discount.

This is in effect what has taken place in the United States thru the action of the Federal Reserve banks. Domestic exchange has disappeared as a charge on the mercantile community, and for the purpose of making payments the whole United States has become a single banking unit.

That does not mean that as a theoretical possibility there is no longer such a thing as domestic exchange. It simply means that its charges have been absorbed into the operating expenses of the Federal Reserve Banking system and are no longer charged to the customer. The case is analogous to your relations to your bank of deposit. Whenever the bank collects for you thru the Clearing House a check on another bank it incurs an expense, whenever it cashes your check it incurs an expense. But these expenses are not charged to you. The bank's operations do not appear as charges in your account, tho if the bank analyzes the latter, they are an important element in determining whether your account is profitable to the bank.

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